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No.

In The

Supreme Court of the United States

October Term, 1994

C. STEPHEN BABIN, BETTY BOEHM BABIN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

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84 pp

QUESTION PRESENTED

Petitioner C. Stephen Babin was a general partner in a partnership that was discharged from an indebtedness by one of its creditors. Generally, such discharge results in the recognition of income. However, the judicial insolvency exception provides that such income is not recognized if the taxpayer is insolvent both before and after the discharge. The question presented is:

Whether, pursuant to 26 U.S.C. § 705(a), petitioner C. Stephen Babin's share of discharge of indebtedness income not recognized by reason of the judicially created insolvency exception will increase the adjusted basis of his interest in the partnership to prevent the taxation of otherwise excluded income.

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No.

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Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

Petitioners, C. Stephen and Betty Boehm Babin, respectfully pray for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App. B, *infra*, 3a-18a) is reported at 23 F.3d 1032 (1994). The opinion of the United States Tax Court (App. D, *infra*, 21a-56a) is unreported.

STATEMENT OF JURISDICTION

The Court of Appeals entered its judgment on May 6, 1994 (App. C, *infra*, 19a-20a). The Court of Appeals denied a timely petition for rehearing en banc on July 7, 1994. (App. A, *infra*, 1a-2a).

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

26 U.S.C. § 705(a)[1] provides in relevant part that "the adjusted basis of a partner's interest in a partnership shall ... be ... increased by the sum of his distributive share for the taxable year and prior taxable years of — (A) taxable income of the partnership.... (B) income of the partnership exempt from tax under this title...."

This case concerns other sections of the Internal Revenue Code and Treasury Regulations listed below and reprinted at App. E, *infra*, 57a-63a:

Internal Revenue Code of 1954 (26 U.S.C.):

§ 61(a)(3)

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1. All statutory references are to the Internal Revenue Code and applicable regulations for the taxable year in issue, unless otherwise indicated.

§ 61(a)(12)
§ 701
§ 702(a)
§ 702(b)
§ 705(a)
§ 731(a)
§ 733
§ 752(a)
§ 752(b)

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.61-12(a)
§ 1.61-12(b)(1)

STATEMENT OF THE CASE

This case originated in the United States Tax Court. Petitioners C. Stephen Babin and Betty Boehm Babin, husband and wife, sought a redetermination of a deficiency in income tax proposed by respondent, Commissioner of Internal Revenue, for the taxable year 1978. Petitioners maintain that respondent and the courts below improperly applied the partnership tax provisions of the Internal Revenue Code, in conjunction with the general rules of the Code and existing case law, to effectively subject to taxation excluded debt discharge income.

A. The Transactional Background.

Petitioner C. Stephen Babin ("Babin"),[2] was one of two

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2. Although petitioner Betty Boehm Babin is also liable for any tax deficiency, the issue on appeal and in this petition only concerns C. Stephen Babin. Accordingly, the terms petitioner or Babin relate solely to C. Stephen Babin.

general partners of Lakewood Center Medical Construction Associates (the "Partnership"), an Ohio limited partnership formed in 1974. The Partnership's primary asset was a medical office building. Construction of the medical office building was financed by the Cleveland Trust Company ("Cleveland Trust").

Cleveland Trust eventually had to institute foreclosure proceedings on the medical building. In response, the Partnership filed a petition in April 1977 under Chapter XII of the Bankruptcy Act. In 1978, the Partnership and Cleveland Trust negotiated a Bankruptcy Court-approved settlement of the Partnership's debt. As part of the settlement, Cleveland Trust forgave $2,420,019 of Partnership debt.

In April 1989, respondent issued a notice of deficiency to Babin. The notice informed Babin that he must recognize additional income from his distributive share of the income realized by the Partnership as a result of the indebtedness cancelled by Cleveland Trust. Babin's share of cancelled indebtedness income exceeded the adjusted basis of his interest in the Partnership. Respondent did not, however, take Babin's personal insolvency into account or apply the judicial insolvency exception to the income recognized.

B. Proceedings Below.

Babin timely filed a petition in the Tax Court that challenged respondent's determination. Babin argued that because he was insolvent both before and after the discharge of the Cleveland Trust indebtedness, the insolvency exception applied. His share of the Partnership discharge of indebtedness income, therefore, should not be recognized by him. Babin contended further that this income, although not required to be recognized because of the insolvency exception, nevertheless increased the adjusted basis of his interest in the Partnership, pursuant to 26 U.S.C. § 705(a). Accordingly, Babin maintained that before respondent calculated capital gain, respondent should have increased the adjusted basis

of Babin's interest in the Partnership by his distributive share of the debt forgiveness income the Partnership realized.

Although debt cancellation income is generally included in gross income, *see* 26 U.S.C. § 61(a)(12), *United States v. Kirby Lumber,* 284 U.S. 1 (1931), a long-standing judicial exception to this rule provides that a taxpayer who is insolvent both before and after a cancellation of indebtedness occurs is not required to recognize this income. *Dallas Transfer & Terminal Warehouse Co. v. Commissioner,* 70 F.2d 95 (5th Cir. 1934). Hence, income that is realized as a result of the cancellation of indebtedness is not recognized by insolvent taxpayers for Federal income tax purposes. The partners who are allocated a share of the income should obtain an increase in the adjusted basis of their partnership interests, pursuant to 26 U.S.C. § 705(a).

The Tax Court, however, refused to increase Babin's adjusted basis in the Partnership by Babin's distributive share of the debt discharge income. The court held that an increase in basis is allowable only when the debt discharge income is actually recognized. Since the insolvency exception prevented Babin from recognizing debt discharge income, the Tax Court denied any basis increase under 26 U.S.C. § 705(a).

Babin timely appealed from this decision to the Sixth Circuit Court of Appeals. On May 6, 1994, the Sixth Circuit filed its affirming opinion. The Sixth Circuit, applying the insolvency test at the partner level, stated that although the Partnership "received" discharge of indebtedness income, because the Partnership was not a taxpaying entity, the income passed through the Partnership to each of its partners. App. B, *infra,* 10a. The court concluded, however, that because Babin was insolvent at the time the Partnership "received" income from the discharge of indebtedness, Babin did not "receive" his distributive share of that taxable income of the Partnership. App. B, *infra,* 10a-11a. The

court held that since Babin did not receive his distributive share of income, his adjusted basis was not increased. *See* App. B, *infra,* 9a.

On June 2, 1994, Babin timely submitted a petition for rehearing *en banc* to the Sixth Circuit based upon the plain language of 26 U.S.C. § 705(a) and upon the substantial legislative history in support of Petitioner's position. The Sixth Circuit, however denied the rehearing request. *See*, App. A, *infra,* 1a-2a.

This petition timely follows.

REASONS FOR GRANTING THE PETITION

The Federal income tax issue that the Sixth Circuit addressed is of national importance but was erroneously decided. The failure to increase basis by the realized but not recognized income arising from the discharge of partnership indebtedness is incompatible with basic principles of income taxation. Amounts are taxed that otherwise would not be subject to taxation, and existing partnership tax law has been contradicted. Furthermore, the issue is encountered each time that a partnership debt readjustment occurs. Moreover, the decision below conflicts in principle with *Estate of Newman v. Commissioner,* 934 F.2d 426 (2d Cir. 1991). The need for guidance from this Court is acute, and this case presents a timely and rare opportunity to provide that guidance.

I.

THE DECISION OF THE COURT OF APPEALS IS ERRONEOUS ON AN IMPORTANT ISSUE OF PARTNERSHIP INCOME TAXATION.

A. The Plain Language Standard.

Statutes which are plain and unambiguous on their face generally must be applied in accordance with their terms. *United*

States v. Ron Pair Enterprises, Inc., 489 U.S. 235, 241 (1989). The statute at issue in this matter, 26 U.S.C. § 705(a), is a plainly stated, unambiguous statute. It provides that the adjusted basis of a partner's interest in a partnership will be increased both by (1) his distributive share of the taxable income of the partnership and (2) his distributive share of the tax exempt income of the partnership. Partnership income which results from the discharge of indebtedness is either taxable or tax exempt, but under either characterization, such income should increase the adjusted basis of a partner's interest in the partnership pursuant to the plain language of 26 U.S.C. § 705(a).

The Sixth Circuit's holding is without precedent. By stating that Babin cannot increase the adjusted basis of his interest in the partnership by the amount of his distributive share of cancellation of indebtedness income realized by the partnership, the Court below directly contradicts the plain, very specific language of 26 U.S.C. § 705(a). The result is that nontaxable income is now subject to taxation. Moreover, it also contradicts the legislative history underlying the enactment of this Internal Revenue Code section.

B. Legislative History—1954.

In explaining that a partner's adjusted basis in his partnership interest *must* be increased by taxable *and* nontaxable income to prevent the unintended taxation of the nontaxable income, the Senate Finance Committee stated:

> The adjustments to the basis of a partner's interest are necessary to prevent unintended benefit or detriment to the partners. Thus, a partner's share of nontaxable income (such as exempt income or depletion allowances in excess of basis) is added to the basis of his interest in the partnership so that the benefit of

> such tax-exempt income will not be lost to the partner. Otherwise, the partner would eventually incur a capital gain with respect to such amounts.

S. Rept. No. 1622, 83d Cong., 2d Sess. 384 (1954). *See also,* H.R. No.1337, 83d Cong., 2d Sess. A225 (1954).

The basis increase for nontaxable income does not result in a double benefit or windfall to the partner, as the Sixth Circuit mistakenly indicated (Cf. App. B, *infra,* 14a). The increase is needed, however, to *prevent* an unintended detriment from occurring.[3] The Senate Finance Committee identified the consequences of a failure to allow a basis increase; *i.e.*, the partner would incur a capital gain with respect to the nontaxable income. The legislative history pinpoints the telltale sign of error in the Sixth Circuit's holding — denying the basis increase causes Babin to incur a capital gain as a result of the debt cancellation.

C. Legislative History—1980.

The plain language of Code section 705(a) was indirectly revisited in the legislative history to the Bankruptcy Tax Act of 1980, P.L. 96-589, two years after the tax year in issue before the Court. The Act itself did not codify a provision mandating a basis increase, but the legislative history clearly indicated the continuing mandate of such an increase:

> Accordingly, income from discharge of a partnership debt is not excludable at the partnership level under amended section 108. Instead, such income is treated as an item of

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3. Note that the failure to increase basis by *taxable* income would also result in an unintended detriment. The increase in basis is needed to prevent a second level of taxation.

> income which is allocated separately to each partner pursuant to section 702(a) of the Code.
>
> *This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (sec. 705).*

S. Rep. No. 1035, 96th Cong., 2d Sess. 21 (1980) (emphasis added).

The 1980 Act did not amend 26 U.S.C. § 705(a) to provide expressly for this result. Congress understood that no amendment was necessary, because the 1954 legislative history of 26 U.S.C. § 705(a) already provided that a partner's basis must be increased for tax-exempt income (such as discharge of indebtedness income), as well as for taxable income. Thus, the 1980 Act augments the Petitioners' position that a basis increase would be required by the plain language of 26 U.S.C. § 705(a) for tax year 1978. To allow the Sixth Circuit decision to stand will throw current partnership tax law into confusion and will frustrate the clearly expressed intention of Congress.

D. Legislative History—1993.

The basis increase for partners who receive tax-exempt income was again recently affirmed by Congress in the legislative history to amendments made to the Internal Revenue Code of 1986 by the Revenue Reconciliation Act of 1993, P.L. 103-66. This legislation, in part, enacted subsections 108(a)(1)(D) and 108(c), which together provide a new exclusion from taxable income for income resulting from certain discharges of indebtedness secured by real property. Congress once again confirmed that under 26 U.S.C. § 705(a), the partner's adjusted basis in his partnership interest must be increased by his share of the excluded cancellation of indebtedness income:

> The deemed distribution (under Code section 752) arising from the reduction in a partner's share of partnership liabilities attributable to the discharge of partnership debt is treated as follows. *The allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (sec. 705).*

H.R. No.11, 103d Cong., 1st Sess., 186 (1993) (emphasis added). In this most recent legislative history on the subject, Congress has again reaffirmed its original intention expressed in the 1954 and 1980 histories.

Thus, all of the controlling statutory references on this issue *require* that a partner who receives nontaxable income must increase his basis by the amount of that income. The decision below, however, abnegates this statutory mandate, with the result that nontaxable income is erroneously subject to taxation. The issue involved in this case does not present an obscure rule of law, but one that is encountered everyday.

E. The Sixth Circuit Decision is Incompatible with Basic Principles of Income Taxation.

As support for its opinion, the Sixth Circuit cited and quoted extensively from *Basye v. United States,* 410 U.S. 441 (1973). However, as stated in *Basye,* the lower court decisions were "incompatible with basic principles of income taxation." 410 U.S. at 442. In this matter, the Sixth Circuit decision is directly contrary to the plain language of 26 U.S.C. § 705(a) and to clearly expressed Congressional intent.

Moreover, as a result of the Sixth Circuit's holding, one of the basic mechanisms for assuring equitable results in the partnership

tax area, *i.e.*, the adjustment to a partner's basis for income or loss, is severely undermined. If this decision is permitted to stand, it will have serious tax consequences to partners who are allocated excluded income. Congress has spoken several times on this issue, but the action below causes a gross breach of basic tax principles that this Court has the power to easily remedy.

II.

THE QUESTION PRESENTED HAS BROAD IMPORTANCE.

This case involves an important question of partnership tax law. The effect of the Sixth Circuit's ruling virtually eliminates the insolvency exception for insolvent partners. The ruling will have frequent application, arising whenever an insolvent partner receives a pass-through of debt discharge income from a partnership. The insolvency exception is an important tax principle, similar to the "fresh start" concept in bankruptcy, and its impairment could be expected to severely harm insolvent taxpayers, particularly those in the real estate industry which typically conduct their business in partnership form.

Furthermore, since the augmenting legislative histories of 1980 and 1993 were not codified as to basis increase, as no amendment of 26 U.S.C. § 705(a) was necessary, the Sixth Circuit and other courts are likely to fail to follow the Internal Revenue Code's intent. Thus, the reasons supporting this petition are timely today and have broader application than the instant litigation alone.

Moreover, distinguished scholarly commentary questions the result of the Tax Court's (and now the Sixth Circuit's) failure to heed the plain language of 26 U.S.C. § 705(a). The leading partnership tax treatise, which has been cited with approval in over

70 court opinions, criticized the Tax Court's decision as follows:

> In C. Stephen Babin, 64 TCM 1357 (1992), however, the partner was *insolvent;* the Tax Court nevertheless denied a basis increase attributable to the debt cancellation. The net result of *Babin* was to create § 731 gain where no income at all would have arisen outside the partnership context, a result that is inconsistent with the thrust of Revenue Ruling 71-301, 1971-2 CB 256.

McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners,* Supp. § 9.02(2)(a)(ii), n. 157 (2nd ed. 1990 and Supp. No. 4, 1993).

Prior to the Bankruptcy Tax Act, the authors of this same treatise wrote:

> If partnership discharge income is segregated and passed through to the partners under § 702(a)(7), it should increase the basis of their interests under § 705(a), regardless of whether all or a portion of the discharge income is subject to the insolvency exception in the hands of the partners.

McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners,* ¶ 9.06(3)(b) at p. 9-39 (First edition 1977). Such commentary further suggests the broader implications than the instant litigation alone resulting from a judicial failure to consider the controlling rule of 26 U.S.C. § 705(a) in this matter.

III.

THE SIXTH CIRCUIT COURT OF APPEALS' APPLICATION OF THE INSOLVENCY EXCEPTION CONFLICTS IN PRINCIPLE WITH THE SECOND CIRCUIT'S APPLICATION.

In *Estate of Newman, supra*, the Second Circuit Court of Appeals faced the issue of how the judicial insolvency exception is to be applied in the partnership context. The court was presented with the question at which level, partnership or partner, the insolvency exception is to be applied. The court determined that the insolvency exception applied at the partnership level. Under *Newman,* the solvency or insolvency of the partnership is to be tested, not that of the individual partners.

The Second Circuit's partnership level approach is in direct conflict with both the Sixth Circuit's partner level approach in this case and with the Tax Court's partner level approach in its decision below, *see* App. C, *infra,* 33a, 34a, 49a, and in *Gershkowitz v. Commissioner,* 88 T.C. 984 (1987).

Another potential conflict is with *Stackhouse v. United States,* 441 F.2d 465 (5th Cir. 1971). The Tax Court has stated that the Fifth Circuit had not considered the level at which the insolvency exception applied, see *Gershkowitz* at 1007, but the Second Circuit, in direct refutation of the Tax Court, contends that the Fifth Circuit applied a partnership level test of insolvency. *See Newman, supra,* at 433, 434.

This disparity in views among the various lower courts that have considered this issue and the absence of a complete and satisfactory analysis of the tax consequences demonstrates the urgent need for this Court to provide its guidance to finally resolve this conflict and clarify existing tax law.

CONCLUSION

WHEREFORE, for the reasons set forth above, petitioners respectfully request that the Court grant this petition for a writ of certiorari.

Respectfully submitted,

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APPENDIX A — ORDER DENYING PETITION FOR REHEARING OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT FILED JULY 7, 1994

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 93-1614

C. STEPHEN BABIN; BETTY BOEHM BABIN,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

ORDER

BEFORE: MILBURN and GUY, Circuit Judges; and TIMBERS,* Circuit Judge.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original hearing panel.

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* Hon. William H. Timbers, Senior Circuit Judge for the U.S. Court of Appeals for the Second Circuit, sitting by designation

Appendix A

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

s/ Leonard Green
Leonard Green, Clerk

APPENDIX B — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT FILED MAY 6, 1994

No. 93-1614

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

STEPHEN BABIN; BETTY BOEHM BABIN,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

On Appeal from the United States Tax Court

Decided and Filed May 6, 1994

Before: MILBURN and GUY, Circuit Judges; and TIMBERS, Senior Circuit Judge.*

MILBURN, Circuit Judge. Petitioner C. Stephen Babin appeals the judgment of the Tax Court finding him liable for federal tax deficiencies for the year 1978, among others.[1] On

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* The Honorable William H. Timbers, Senior Circuit Judge of the United States Court of Appeals for the Second Circuit, sitting by designation.

1. Although the Tax Court determined that petitioner Betty Boehm Babin also was liable for certain deficiencies, the issue on appeal only concerns C. Stephen Babin. Accordingly, the term petitioner solely relates to C. Stephen Babin.

appeal, the sole issue is whether the Tax Court erred in failing to increase the adjusted basis of petitioner's interest in a partnership under 26 U.S.C. § 705(a)(1)(A) by the amount of the discharge of indebtedness income that petitioner did not have to recognize by reason of the judicially created insolvency exception. For the reasons that follow, we affirm.

I.

A.

In 1974, the Lakewood Center Medical Construction Associates ("Partnership"), an Ohio limited partnership, was formed. Petitioner, one of two general partners of the Partnership, held a 51% interest in the income and loss of the Partnership and a 75% interest in the Partnership's liabilities. The other general partner and the six limited partners held the remaining interests of the Partnership. The Partnership's primary asset was a 70,000 square foot medical office building adjacent to Lakewood Hospital. Construction of the medical office building was financed by the Cleveland Trust Company ("Cleveland Trust"), which held both a first and second mortgage on the building and also debtor's certificates. All the debt held by Cleveland Trust was recourse as to the two general partners.

Upon the failure of the Partnership to maintain the debt service payments, Cleveland Trust instituted foreclosure proceedings on the medical building, and the Partnership filed a petition in April 1977 under Chapter XII of the Bankruptcy Act. During the bankruptcy proceedings, the Partnership agreed to sell all its assets to a third party for $2,850,000. In addition, the Partnership and Cleveland Trust discussed the settlement of the Partnership's debts. At the time, the Partnership was indebted to Cleveland Trust in the amount of $5,170,019.

Appendix B

The Partnership and Cleveland Trust subsequently agreed to the resolution of the Partnership's debt. Under the settlement agreement, the Partnership agreed to pay Cleveland Trust $2,750,000 in full satisfaction of the two mortgages and the debtor's certificates. In return, Cleveland Trust agreed to forgive $2,420,019, the remaining portion of the debt owed by the Partnership. In January 1978, a bankruptcy court approved the settlement and dismissed the proceedings.

B.

In April 1989, respondent Commissioner of Internal Revenue issued a notice of deficiency to petitioner for three tax years: 1978, 1979, and 1982. The notice informed petitioner of several determinations made by respondent, including the determination that petitioner must recognize an increased amount of income as a result of the transactions involving the Partnership and Cleveland Trust. As relevant to this appeal, respondent determined that the Partnership received a total of $5,270,019 from the sale of its assets and the discharge of its indebtedness; $100,000 from the sale proceeds from the third party and $5,170,019 from discharge of the indebtedness to Cleveland Trust. Respondent also determined that petitioner's share of this amount, $3,952,514 (75% of $5,270,019), exceeded the adjusted basis of petitioner's interest in the Partnership, $2,663,180, by $1,289,334. Accordingly, respondent determined that petitioner had to recognize $1,289,334 in capital gain. *See* 26 U.S.C. § 731(a). Because the year at issue in this case antedates the Tax Reform Act of 1986, our statutory references are to the Internal Revenue Code of 1954.

Petitioner thereafter filed a petition in the Tax Court challenging, among other things, the calculation with respect to capital gain. Petitioner argued that before respondent calculated

capital gain, respondent should have increased the adjusted basis of petitioner's interest in the Partnership, pursuant to 26 U.S.C. § 705(a)(1)(A), by petitioner's distributive share of the income the Partnership realized upon the forgiveness by Cleveland Trust of the $2,420,019 owed by the Partnership. Had respondent increased petitioner's adjusted basis in the manner urged by petitioner, petitioner would have recognized little or no capital gain as opposed to recognizing $1,289,334 in capital gain as determined by respondent. The Tax Court, however, rejected petitioner's argument and affirmed respondent's calculations in this respect. This timely appeal followed.

II.

Resolution of whether the Tax Court erred in failing to increase the adjusted basis of petitioner's interest in the Partnership pursuant to 26 U.S.C. § 705(a)(1)(A) is a question of law. *Estate of Newman v. Commissioner,* 934 F.2d 426, 434 (2d Cir. 1991). Thus, we review the judgment of the Tax Court de novo. *North American Rayon Corp. v. Commissioner,* 12 F.3d 583, 586 (6th Cir. 1993). In order to reach our conclusion, we must analyze several distinct portions of the Internal Revenue Code, each of which operate independently.

We begin with the rule that the discharge of a debt below face value accords the debtor an economic benefit functionally equivalent to income. This rule was first articulated by the Supreme Court in *United States v. Kirby Lumber Company,* 284 U.S. 1 (1931). In that case, a corporation issued its own bonds for approximately $12,000 for which it received their par value. During the same year, the corporation purchased some of the bonds at less than par value. The difference in price was $137,521.30. Reasoning that "[a]s a result of its dealing [the corporation] made

available $137,521.30 [of] assets previously offset by the obligation of bonds now extinct," the Supreme Court concluded that the corporation "realized within the year an accession to income." *Id.* at 3. In 1954, Congress codified the ruling in *Kirby Lumber,* specifically providing that gross income includes "[i]ncome from discharge of indebtedness." 26 U.S.C. § 61(a)(12). Thus, in general, where a debt owed by a taxpayer is discharged, the difference between the face value of the debt and the amount paid in satisfaction of the debt is includable in the taxpayer's gross income under 26 U.S.C. § 61(a)(12).

Accompanying the discharge of indebtedness income rule, however, is a judicially created exception, commonly referred to as the "insolvency exception." Under the insolvency exception, "a debtor will not recognize income under section 6l(a)(12) if he is insolvent following the discharge of indebtedness." *Gershkowitz v. Commissioner,* 88 T.C. 984, 1005 (1987) (citing *Dallas Transfer & Terminal Warehouse Co. v. Commissioner,* 70 F.2d 95 (5th Cir. 1934) and *Astoria Marine Constr. Co. v. Commissioner,* 12 T.C. 798 (1949)).

> The theory of this exception is that no accession to income has occurred if after the debt cancellation, the taxpayer remains insolvent since no assets have been freed. To the extent the cancellation renders the taxpayer solvent, however, he is deemed to have realized income in the amount by which his assets exceed his liabilities immediately after the cancellation.

Estate of Delman v. Commissioner, 73 T.C. 15, 32 (1979) (citations omitted); *see also* Jacob Mertens, Jr., *Mertens Law, of Federal*

Taxation, § 11.42 (1990). The insolvency exception, among other things, is premised on the belief that it is inequitable "to kick someone when he is down." 1 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, ¶ 6.4.1 at 6-27 (2d ed. 1989).

In addition to providing for the rules governing whether a partner realizes income under 26 U.S.C. § 61(a)(12) as a result of the discharge of indebtedness, the Internal Revenue Code also provides separate and distinct rules governing whether a partner recognizes capital gain under 26 U.S.C. § 731(a)(1) as a result of the discharge of indebtedness. Under the partnership provisions of the Internal Revenue Code, "a partner's interest in the partnership is itself a capital asset, subject to gain or loss like any other capital asset." *Stackhouse v. United States*, 441 F.2d 465, 467 (5th Cir. 1971). As relevant to this case, the calculation of capital gain requires the determination of two separate factors: (1) the amount of money, if any, distributed by the partnership to the partner; and (2) the adjusted basis of such partner's interest in the partnership immediately before the distribution. If the money distributed by the partnership to the partner exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, then the excess amount of money distributed must be recognized as capital gain. 26 U.S.C. § 731(a)(1). Section 705(a)(1)(A) is the relevant provision in this case to the determination of the adjusted basis of a partner's interest in the partnership.

Applying these principles, the Tax Court made two conclusions. First, it concluded that because petitioner was insolvent both before and after the discharge of the debt held by Cleveland Trust, the insolvency exception mandated that petitioner recognize no income under 26 U.S.C. § 61(a)(12) from

the discharge of indebtedness income. Neither party argues on appeal that the Tax Court erred in this conclusion. Second, the Tax Court concluded that because petitioner was insolvent both before and after the discharge of the debt held by Cleveland Trust, and thus did not recognize income, petitioner was barred from increasing the adjusted basis of his interest in the Partnership under 26 U.S.C. § 705(a)(1)(A). Accordingly, the Tax Court determined that petitioner had to recognize capital gain. Whether the Tax Court erred in failing to increase the adjusted basis of petitioner's interest in the Partnership under 26 U.S.C. § 705(a)(1)(A) is the issue on appeal.

Section 705(a)(1)(A) provides that the adjusted basis of a partner's interest in a partnership shall be increased by the partner's "distributive share . . . of . . . taxable income of the partnership." In this case, petitioner argues that when Cleveland Trust forgave $2,420,019 of the debt the Partnership owed, that amount constituted "taxable income of the Partnership." Petitioner then argues that because he was a general partner holding 51% of the income of the Partnership, he received his "distributive share" of that taxable income of the Partnership; specifically, $1,234,210 (51% of $2,420,019). As a result, petitioner argues that under 26 U.S.C. § 705(a)(1)(A) he should be able to increase the adjusted basis of his interest in the Partnership by $1,234,210.

We disagree with petitioner and conclude that because petitioner was insolvent at the time the Partnership received $2,420,019 in income as a result of Cleveland Trust's agreement to forgive that amount, petitioner did not receive his distributive share of that taxable income of the Partnership. The unique nature of a partnership as it relates to the Internal Revenue Code was described by the Supreme Court in *United States v. Basye*, 410 U.S. 441 (1973):

Appendix B

> Section 703 of the Internal Revenue Code of 1954, insofar as pertinent here, prescribes that "[t]he taxable income of a partnership shall be computed in the same manner as in the case of an individual." 26 U.S.C. § 703(a). Thus, while the partnership itself pays no taxes, 26 U.S.C. § 701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.

Id. at 448.

Under the framework provided in *Basye,* when Cleveland Trust forgave $2,420,019 of the debt the Partnership owed, the Partnership received that amount as discharge of indebtedness income. Because the Partnership was not a tax paying entity, however, the discharge of indebtedness income received by the Partnership was to pass through to each partner in proportion to each partner's distributive share of the income of the Partnership. But in this case, petitioner was insolvent both before and after the forgiveness of the $2,420,019. As a result, no taxable income passed through to petitioner as a result of the discharge of that debt. Since petitioner did not receive any taxable income, there was no distributive share of taxable income of the Partnership within the

meaning of 26 U.S.C. § 705(a)(1)(A) which would have entitled petitioner to increase the adjusted basis of his interest in the Partnership. Accordingly, petitioner is not permitted to increase the adjusted basis of his interest in the Partnership.

Petitioner argues, however, that if he were not allowed to increase the adjusted basis of his interest in the Partnership under 26 U.S.C. § 705(a)(1)(A), he effectively would end up paying tax on the discharge of indebtedness income. Petitioner suggests that if he were required to pay tax on the discharge of indebtedness income, the insolvency exception would be rendered meaningless. To illustrate his point, petitioner sets forth three variations of the facts in this case and describes the applicable tax consequences. In each example, the hypothetical partner's adjusted basis in the partnership prior to the discharge of indebtedness is $2,663,180; the partner's distributive share of the partnership's discharge of indebtedness income is $1,234,210; and the partner's share of the partnership's discharged liabilities is $3,877,514.

In petitioner's first example, the partner at issue is solvent as opposed to insolvent as in this case. Because the partner is solvent, when the partnership realizes $2,420,019 in discharge of indebtedness income due to the forgiveness of a debt in that amount, the partner cannot invoke the insolvency exception and thus realizes his distributive share of that amount under 26 U.S.C. § 61(a)(12). In petitioner's example, the distributive share of the partner is $1,234,210. Pursuant to 26 U.S.C. § 705(a)(1)(A), the partner must then increase the adjusted basis of his interest in the partnership by $1,234,210, thus increasing the adjusted basis from $2,663,180 to $3,897,390. Moreover, as noted by petitioner, the discharge in partnership liabilities not only generates discharge of indebtedness income but also results in a deemed distribution of money under 26 U.S.C. § 752(b) in the amount of the partner's

share of the discharged liabilities, which in this hypothetical is $3,877,514. Pursuant to 26 U.S.C. § 733 and 26 U.S.C. § 705(a)(2), this deemed distribution reduces the partner's adjusted basis from $3,897,390 to $19,876. Consequently, the ultimate tax effect in this example is that the partner pays tax on $1,234,210 related to the discharge of indebtedness income and the partner's adjusted basis has been reduced to $19,876. Under this example, no capital gain is recognized.

In petitioner's second example, the partner is insolvent but is allowed to increase his basis. Under this scenario, because the insolvency exception applies, the partner will not pay tax on his distributive share of the discharge of indebtedness income, $1,234,210. Pursuant to 26 U.S.C. § 705(a)(1)(A), however, the partner will still be able to increase the adjusted basis in his interest in the partnership by the discharge of indebtedness income. Thus, in this scenario, the adjusted basis would be $3,897,390, the same as in the first example. Pursuant to 26 U.S.C. § 752(b), the discharge of liabilities by the partnership results in a deemed distribution of money to the partner in the amount of $3,877,514. Under 26 U.S.C. § 733 and 26 U.S.C. § 705(a)(2), this deemed distribution of money reduces the partner's adjusted basis from $3,897,390 to $19,876. The ultimate tax effect in this example is that under the insolvency exception the partner has paid no tax on the discharge of indebtedness income and the partner has reduced his adjusted basis to $19,876. Additionally, as in the first example, no capital gain is recognized.

The third and final example also assumes that the partner is insolvent. Thus, as in the second example, the partner will not pay tax on his distributive share of the discharge of indebtedness income, $1,234,210, because of the insolvency exception. But unlike the second example, the partner is not permitted to increase

his adjusted basis under 26 U.S.C. § 705(a)(1)(A). Accordingly, the partner's adjusted basis remains at $2,663,180. Pursuant to 26 U.S.C. § 752(b), the discharge of the partnership's liabilities results in a deemed distribution of money to the partner in the amount of $3,877,514. However, because there has been no adjusted basis increase, the taxpayer must recognize capital gain in the amount of $1,214,334 ($3,877,514 minus $2,663,180) under 26 U.S.C. § 731(a). Additionally, the partner's remaining adjusted basis will be zero. The ultimate tax effect in this example is that the partner ends up paying tax on $1,214,334 and his remaining adjusted basis has been reduced to zero.

Petitioner argues that this case should be resolved as set forth in the second example, not the third which respondent seeks to defend. Petitioner argues that if we were to accept respondent's argument and approve of the calculations set forth in example three, petitioner would be forced to pay tax on virtually the same amount as if he had been solvent. According to petitioner, this is not the result intended by the insolvency exception.

Petitioner's argument, however, overlooks the fact that in this case, as in example three, he is not paying tax on the discharge of indebtedness income, but rather, he is paying tax on the deemed distribution of money as a result of the decrease in the Partnership's liability. As evident in petitioner's own examples, the amount generated from the discharge of indebtedness and the amount generated from the deemed distribution of money as a result of that discharge require completely separate analyses. Thus, if petitioner were correct in arguing that he is allowed to increase the adjusted basis of his interest in the Partnership by the discharge of indebtedness income that he was not, and will never be, required to recognize and pay tax on, then not only will petitioner avoid the ordinary income tax on his share of the partnership's discharge of

indebtedness income, but he will also avoid tax on the deemed distribution of money to him of his interest in the liabilities that he previously used to increase his adjusted basis. We refuse to sanction such a windfall to petitioner.

In urging us to conclude that the Tax Court erred in failing to increase the adjusted basis, petitioner relies on the following passages of the Tax Court decision in *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987):

> "In general, gross income includes income from the discharge of indebtedness. *Income realized* by a partnership on the discharge of indebtedness is passed through to each partner under section 702, and the partner's basis in his partnership interest is increased by his distributive share of *such income*. Under a judicially created exception to this rule, however, a debtor will not *recognize* income under section 61(a)(12) if he is insolvent following the discharge of indebtedness."
>
> * * *
>
> "Under section 61(a)(12), the [partnerships] *realized* income from the discharge of indebtedness when [the creditor] discharged the loans. This income was then passed through to the individual partners pursuant to section 702(a)(8)."

Reply Brief for Appellant at 3-4 (quoting *Gershkowitz*, 88 T.C. at 1005-06) (citations omitted) (emphasis added by petitioner).

Based on these passages, petitioner argues that because discharge of indebtedness income realized by the Partnership upon the discharge of the Cleveland Trust debt was passed through to him, the adjusted basis of his interest in the Partnership should be increased by his distributive share of that income even though the insolvency exception may preclude him from ultimately recognizing that income.

We are unpersuaded by petitioner's selective reading of *Gershkowitz*. In *Gershkowitz*, the Tax Court was faced with whether to increase the adjusted bases of *solvent* partners, as opposed to an *insolvent* partner as in this case, where the partnerships at issue were insolvent after the discharge of indebtedness. In the course of setting forth the applicable Internal Revenue Code provisions, the Tax Court acknowledged that, as a general rule, income realized by a partnership on the discharge of indebtedness is passed through to each partner and that under 26 U.S.C. § 705(a)(1), the partner's adjusted basis is increased by his distributive share of that discharge of indebtedness income. However, these statements, upon which petitioner relies, do not constitute the holding of the Tax Court. Instead, the holding of the Tax Court appears later in the opinion where the Tax Court concluded that because each partner was solvent at the time the partnerships' debts were discharged, each of the partners were required to recognize the discharge of indebtedness income and correspondingly increase their adjusted bases under 26 U.S.C. § 705(a)(1). *Gershkowitz*, 88 T.C. at 1009.

Thus, contrary to petitioner's suggestion, the Tax Court in *Gershkowitz* did not hold that the partners were required to increase their adjusted bases simply because the partnership realized discharge of indebtedness income which was passed down to the partners. Rather, in reaching its conclusion, the Tax Court

found it crucial that the partners were solvent, thereby rendering the insolvency exception inapplicable. Accordingly, we decline to read *Gershkowitz* in the manner suggested by petitioner.

In further support of his position, petitioner relies on Revenue Ruling 71-301, 1971-2 C.B. 256. In that revenue ruling, the Internal Revenue Service, among other things, considered the application of 26 U.S.C. § 731(a) with respect to the discharge of a partnership and its partners from indebtedness under section 14 of the Bankruptcy Act. Although it determined that the distribution of money by the partnership to the partner caused by the discharge exceeded the adjusted basis of the partner's interest in the partnership immediately prior to distribution, the IRS concluded that no gain was recognized by the partner because the partner was insolvent after the discharge. Petitioner argues that based on the conclusion in Rev. Rul. 71-301, he likewise should not be required to recognize gain in this case because he was insolvent after the discharge of the Cleveland Trust debt.

We decline to apply the reasoning of Rev. Rul. 71-301 to the facts in this case. Revenue rulings are not binding on this court. *Foil v. Commissioner,* 920 F.2d 1196, 1201 (5th Cir. 1990). Nor are revenue rulings "entitled to the deference accorded a statute or a Treasury Regulation." *Threlkeld v. Commissioner,* 848 F.2d 81, 84 (6th Cir. 1988). But because revenue rulings express the studied view of the IRS, whose duty is to carry out the provisions of the Internal Revenue Code, they are entitled to some deference. *Central, Inc. v. United States,* 953 F.2d 1051, 1056 (6th Cir. 1992). However, we need not accord a revenue ruling any deference, where, as here, the revenue ruling fails to address the relevant issue on appeal. Rev. Rul. 71-301 concluded that 26 U.S.C. § 731(a), the provision providing for the recognition of capital gain, is not applicable when partnership liabilities were discharged in

bankruptcy, but it made no statement as to whether the partners were entitled to increase the adjusted basis of their interests in the partnership as a result of the discharge of indebtedness income, the precise issue in this case. Petitioner apparently recognizes the distinguishing element of the revenue ruling to this case by only arguing that in Rev. Rul. 71-301, "[t]he Internal Revenue Service has . . . considered a situation *substantially similar* to that involving petitioner]." Brief for Appellant at 27 (emphasis added).

Finally, petitioner argues that had he owned the Partnership assets as a sole proprietor or as a co-tenant and had he engaged in the same transactions as the Partnership, he would not have recognized any income as a result of the discharge of the Cleveland Trust debt. Relying on the principle that "the ideal mode of taxing partnership earnings is to tax each partner as though he were directly conducting his proportionate share of the partnership business," Reply Brief for Appellant at 21 (quotation marks and citations omitted), petitioner argues that if we were to adopt his position, insolvent partners would merely be placed in the same tax position as if the partnership activities had been conducted in a sole proprietorship or held as a tenancy in common. Accordingly, petitioner argues that his argument should prevail because there should be no material distinction in the tax treatment that results from the discharge of the Cleveland Trust debt simply because of the form he chose to hold the property.

We refuse to speculate as to the tax implications petitioner would have faced had he held the Partnership assets as a sole proprietor, as a tenant in common, or, for that matter, in any other type of relationship. When taxpayers select a particular form to hold property, they may not enjoy the tax benefits offered by that form and at the same time seek to avoid the adverse tax consequences. *United States v. Scornavacco's Restaurant, Inc.*,

528 F.2d 19, 23 (7th Cir. 1975). Thus, given his choice to hold property in a partnership, petitioner is bound by the provisions in the Internal Revenue Code which govern such entities.

III.

For the reasons stated, the judgment of the Tax Court is AFFIRMED.

APPENDIX C — JUDGMENT ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT FILED MAY 6, 1994

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No.: 93-1614

C. STEPHEN BABIN and BETTY BOEHM BABIN,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Before: Milburn and Guy, Circuit Judges; and
Timbers, Senior Circuit Judge.

JUDGMENT

ON APPEAL from a decision of the United States Tax Court.

THIS CAUSE was heard on the transcript of record from the Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, it is ORDERED that the judgment of the Tax Court is AFFIRMED.

COSTS are taxed against the petitioners, C. Stephen Babin and Betty Boehm Babin.

Appendix C

ENTERED BY ORDER OF THE COURT

s/ Leonard Green, Jr.
Leonard Green, Clerk

A True Copy

Attest:

_____
Deputy Clerk

Issued As Mandate: *7-19-94*

COSTS: *NONE*

Filing Fee .....$
Printing .....$

Total .....$

APPENDIX D — OPINION OF THE UNITED STATES TAX COURT FILED NOVEMBER 23, 1992

T. C. Memo. 1992-673

UNITED STATES TAX COURT

C. STEPHEN AND BETTY BOEHM BABIN, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17993-89. Filed November 23, 1992.

J. Timothy Bender, Aaron H. Bulloff, and *Timothy J. O'Shaughnessy,* for petitioners.

Jeffrey J. Erney, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WELLS, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes as follows:

Year	Deficiency
1978	$130,730
1979	173,179
1982	76,768

After concessions, we must decide several issues in the instant case. The first issue we must decide arises from the discharge of a recourse mortgage debt of a partnership of which petitioner C. Stephen Babin (hereinafter petitioner) was a general partner. We must decide whether petitioners must recognize income from such discharge and, consequently, whether petitioner was insolvent at

the time of such discharge. The second issue we must decide is the amount of capital gain to be recognized by petitioner upon the reduction in his share of partnership liabilities occasioned by such discharge. The third issue we must decide is the amount and character of loss petitioners must recognize upon the dissolution of another partnership in which petitioner held an interest. Lastly, we must decide whether petitioner Betty Boehm Babin is entitled to certain net operating loss carryforwards for 1982.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Certain documents have been stipulated for trial pursuant to Rule 91. When the petition in the instant case was filed, petitioners resided in Fairview Park, Ohio. Immediately before petitioner's marriage to Betty Boehm Babin on January 17, 1976, they executed an antenuptial agreement listing all petitioner's assets.

The Debt Discharge Transaction

Petitioner was a general partner in Lakewood Center Medical Construction Associates (LCMCA), an Ohio limited partnership. LCMCA's primary asset was the newly constructed Lakewood Center Professional Building (the medical building), a 7-story, 70,000 square foot office building adjacent to Lakewood Hospital. Petitioner held a 51-percent interest in the income and loss of LCMCA and a 75-percent share of its liabilities. The other general partner of LCMCA was James Carroll, who held a 17 percent profit/loss interest. LCMCA had six limited partners, including Mrs. Babin.

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Cleveland Trust Company (CTC) held a first mortgage on the medical building of $3,300,110, a second mortgage of $660,014, and debtor's certificates of $220,782 (hereinafter collectively referred to as the "CTC mortgage"). All of the debt held by CTC was recourse as to the general partners. Because LCMCA was unable to make debt service payments, CTC foreclosed on the medical building and LCMCA filed a Chapter XII bankruptcy petition on April 13, 1977. In late 1977, LCMCA and CTC discussed a settlement of the partnership's debts. The total debt owed CTC by LCMCA was $5,170,019, but CTC offered to cancel the debt for $2,750,000, forgiving $2,420,019 of debt.

On October 31, 1977, petitioner contracted to sell to Howard Schulman all of LCMCA's assets, including the medical building, as well as the partners' interest in LCMCA, for a total of $2,850,000, $64,000 of which represented a cash distribution to the partners. The remainder was used to pay various other creditors of LCMCA and expenses incident to the sale. On January 9, 1978, the bankruptcy court approved the settlement reached by LCMCA and CTC and dismissed the proceedings. LCMCA sustained an ordinary loss of $442,265 on the disposition of the medical building, of which petitioner's share was $225,555.

At the time of the sale, Mr. Schulman entered into a Management and Consulting Agreement with petitioner under which Mr. Schulman agreed to award Marwood, Inc., a property management firm owned by petitioner, a 2-year contract as managing and leasing agent for the medical building. Marwood would be compensated at the rate of 4 percent of gross rentals until "break even" cash flow was attained, and such fee would be increased to 5 percent if the "break even" level were attained for 3 consecutive months. Marwood would also receive a leasing fee of 5 percent of the gross lease amount for leases it negotiated. If the

lease rate for the building did not exceed 60 percent within a year of Mr. Schulman's acquisition of the building, Mr. Schulman could cancel the contract. If, however, the lease rate was 80 percent within 18 months, the contract would be automatically extended for a year. Marwood would also receive a supervisory fee of 10 percent of cost for all construction in vacant areas of the building, and a design fee of $1.00 per square foot for design work in areas to be leased up to 2,500 square feet, and a design fee of $.75 per square foot for areas in excess of such size. Marwood was also allowed to bid on construction work to be done in the building.

Under the Management Agreement, petitioner was entitled to 30 percent of annual cash flow, after payment of expenses and repayment of advances made by Mr. Schulman. Petitioner also was entitled to 30 percent of net proceeds from refinancing or sale of the property. Petitioner also entered into a purchase option agreement with Mr. Schulman concerning the medical building.

Petitioner's basis in his interest in LCMCA prior to the debt discharge was $2,663,180, which includes a reduction for the distribution of petitioner's share, $32,640, or 51 percent, of the $64,000 cash payment to the partners of LCMCA by Mr. Schulman. Upon the discharge of the CTC mortgage, petitioner's basis was reduced by $3,877,514 (75 percent of $5,170,019).

Petitioner's Assets as of January 9, 1978

Marwood, Inc.

Petitioner owned all of the stock of Marwood, Inc. (Marwood), the real estate management company which operated the medical building and other buildings in which petitioner had an interest. The buildings generally were operated under management

contracts which could be cancelled on 30 to 60 days notice. Usually, when a building was sold, Marwood was replaced as property manager. Marwood did not seek other properties to manage. Marwood usually received a management fee of between 4 and 5 percent of rental income, a commission on leases it obtained, and fees on construction work for tenants in the buildings. Marwood's assets included office equipment, cash, and receivables. Marwood's expenses exceeded its income in 1977. Marwood's income tax return for the year ended December 31, 1977, shows accounts receivable and assets equalling $143,842 and accounts payable of $137,180. The excess of assets over liabilities totals $6,662.

Petitioner was Marwood's employee, but had no employment contract or noncompetition agreement with Marwood. In 1977, petitioner received a salary of $48,000 from Marwood, as well as a "commission" of $134,358.

14701 Detroit Corp.

Petitioner owned all the stock of 14701 Detroit Corp. (14701 Detroit), the principal assets of which were the INA Building and Annex, a modern 7-story office building, and the Lakewood Center Building, a 3-story office building originally constructed as a department store in the 1920's and extensively remodelled in 1969. The buildings were in average to above-average condition as of January 10, 1978. Both buildings were located on the same block in downtown Lakewood, Ohio, and shared two and three level parking garages, as well as a surface parking lot, which had been constructed on such site for their tenants. The land owned by the corporation had been sold to a real estate investment trust (the REIT), and 14701 Detroit leased the land from the REIT for $175,000 per year at the time in issue. Certain of the land used for

parking had been leased from the City of Lakewood in 1973 by Marwood, Inc., a corporate predecessor of 14701 Detroit. The other assets of 14701 Detroit had a value of $83,172 as of January 9, 1978.

The buildings were encumbered by a first mortgage of $4,863,762, held by Broadview Savings and Loan. As of January 9, 1978, 14701 Detroit was in default on such mortgage. The REIT held a second mortgage of $200,000 on the buildings, which was also in default at such time. The mortgages had a higher payment priority than other corporate debts. 14701 Detroit was also in default on its land lease with the REIT at such time. As of the end of 1977, the corporation's cash flow fell $100,000 short of what was needed to service the debt.

Petitioner held a note from 14701 Detroit in the amount of $746,511, which he received when he assumed a debt in such amount on the corporation's behalf. Such debt was included in a $1,000,000 nonrecourse note given by petitioner to CTC on January 9, 1978, which is discussed further below. Petitioner never wrote the 14701 Detroit note off as worthless on his tax returns.

One of the tenants of 14701 Detroit's buildings was Control Data Corp. (Control Data) which, at the beginning of 1978, was considering moving out of the buildings because it wanted more space. In February 1978, petitioner began negotiating in earnest to try to keep Control Data, promising to secure additional space in the buildings. Control Data signed a 12-year lease with 14701 Detroit on March 30, 1978. The lease provided that Control Data would be able to terminate if the additional space were not made available. In order to provide the space, petitioner had to relocate two tenants in the building, who had not agreed to move when the lease was signed. One tenant's space was to be available to Control

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Data in June 1978 and the other's was to be available in March 1979. Petitioner succeeded in relocating the tenants to the Lakewood Center North Building and made the space available to Control Data. The Control Data lease gave the buildings a positive cash flow of $200,000, and greatly increased the value of the 14701 Detroit stock. On May 7, 1979, petitioner sold his stock in 14701 Detroit for $1,740,157.

Eastates Gas Producing Co.

Petitioner owned 30 percent of the stock of Eastates Gas Producing Co. (Eastates), which he purchased in the early 1970's. Eastates was an oil and gas exploration company, the income of which was derived from oil and gas royalties. Petitioner received the following dividends from Eastates:

Year	Amount
1977	$1,950
1978	3,545
1979	2,150
1980	3,780
1981	0
1982	0

The Eastates stock eventually became worthless but was valued at $20,000 as of January 9, 1978. Petitioner also loaned $100,000 to Eastates in the early 1970s, receiving a debenture in return. Petitioner listed the debenture as an asset on his January 16, 1976, antenuptial agreement, but did not claim a worthlessness deduction on its account on his 1977 through 1982 tax returns. The money was never repaid.

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Rockport Palisades Investment Associates

Petitioner owned a 78 percent interest in Rockport Palisades Investment Associates (RPIA) consisting of 70 general partnership units and 8 limited partnership units. Petitioner was the sole general partner of RPIA. The principal asset of RPIA was the Westlake Hotel (the Westlake), which the partnership acquired in 1974 for $1,355,978. The Westlake, a 1920s vintage structure, had been converted to apartments when RPIA acquired it. It was situated on a 5-acre parcel on the east bank of the Rocky River opposite Lakewood. The Westlake occupied half of the parcel, while the remainder of the parcel consisted of a steep hillside with a marina at its base. Certain retail businesses leased space at the Westlake and a yacht club leased the marina. From 1975 through 1977, operating income was not sufficient to meet debt service requirements, although a small operating profit was attained in 1978.

On December 31, 1977, RPIA had liabilities of $1,332,720, which included accounts payable, notes payable, and the mortgage, all of which were recourse as to petitioner. RPIA's payables included $96,582 owed to Marwood. Additionally,- RPIA owed petitioner $176,601. No material changes in such liabilities occurred prior to January 9, 1978. As of such time, RPIA had other assets with a value of $2,963.

In 1982, RPIA sold the Westlake for $1,637,500. The building was subsequently converted into condominiums at a cost of $3,000,000.

Lakewood Center North Building Associates

Lakewood Center North Building Associates (LCNBA) was a

limited partnership, of which petitioner was a general partner, formed to construct a 15-story office building known as Lakewood Center North. In January 1977, LCNBA was in bankruptcy due to negative cash flow, large deficits, and a lack of tenants. Between January and February 1977, Detroit Belle, a partnership controlled by another real estate developer, was admitted to LCNBA and took a 90-percent interest in such partnership. Furthermore, petitioner's interest was "deep frozen", meaning that Detroit Belle was entitled to all the cash flow from the building until its capital contributions were repaid, and thereafter would receive all of the profits, losses, and cash flow until December 31, 1986, and 90 percent of such items thereafter. In return for its interest, Detroit Belle promised to put more capital into the property and assume liability for its mortgages. Neither petitioner nor LCNBA's limited partners received any cash distribution in connection with the deal. Petitioner reported a capital gain of $2,622,420 from the transaction on his 1977 tax return.

Lakewood Center North Associates

Lakewood Center North Associates (LCNA) was a limited partnership which held certain vacant land near the Lakewood Center North Building. Petitioner was the general partner of LCNA, holding a 20-percent capital interest. The book value of LCNA's assets as of December 31, 1977, was $138,510, with the land valued at historical cost. No effort was made to sell the land or to appraise it at such time. LCNA had liabilities of $5,073, consisting of real estate taxes due, as of December 31, 1977. Petitioner's capital account at such time equalled $23,167.

Associates for Investment in Lakewood

Petitioner held a 40-percent interest and was a general partner

in Associates for Investment in Lakewood (AFIL), a limited partnership which owned a 5-story retail and office building. Mr. James Carroll was also a general partner in AFIL. Petitioner also held a $22,500 note from AFIL on which he never received payment. AFIL had a negative cash flow, was barely able to service its mortgages, and was producing losses in 1977 and 1978. Petitioner made efforts to sell the partnership, and in mid-to-late 1978 the building was transferred in exchange for assumption of its $600,000 in mortgages, with no cash paid to the partnership. AFIL was dissolved after the building was sold. Petitioner made contributions to AFIL's capital of $80,095, which he never recovered.

Venture Associates

Venture Associates (Venture) was a partnership which held a 3/4 working interest in an oil and gas well in southern Ohio. Petitioner held a 3/16 interest in Venture Associates. The production of the well was purchased by Ashland Oil, which in turn sent out checks to the various holders of interests in the well. Petitioner had no stake in Ashland Oil. Between 1977 and 1982, petitioner received distributions from Venture of between $119 and $5,531. Petitioners valued petitioner's interest in Venture at $20,000 based on a capitalization of its income.

Tucker Land Co.

Petitioner owned 3-1/2 limited partnership units of Tucker Land Co. (Tucker), a limited partnership which held a substantial amount of land along Mulholland Drive in the hills overlooking Los Angeles. Petitioner paid between $1,000 and $1,500 for his interest in Tucker. Petitioner reported losses of a few hundred dollars a year from his interest in Tucker for 1977 through 1979 and

income of one to two hundred dollars from such interest for 1980 through 1982.

Miscellaneous Assets

As of December 31, 1977, petitioner had a checking account with a balance of $387 and had no other bank accounts. No substantial changes in the balance of such account occurred between such date and January 9, 1978. Petitioner owned a life insurance policy with a cash surrender value of approximately $5,000 as of January 9, 1978. Petitioner owned personal property with an approximate fair market value of $9,000 on such date. Petitioner owned a 1970 Buick valued at $1,000 and a 1977 Buick valued at $7,000.

Petitioner's Liabilities

As of January 9, 1978, petitioner's debts were as follows: Helen Fowerbaugh, $20,000; Nick Laslovich, $7,000; Continental Bank, $64,800; LCNA, $42,700. On his 1978 tax return, petitioner claimed deductions for interest paid on all the aforementioned obligations.

Petitioner was also liable on a $1,000,000 nonrecourse note held by CTC. Such note was issued on January 9, 1978, as part of the bankruptcy settlement in return for two judgments held by CTC, one against 14701 Detroit for $643,573.69, bearing 8 percent interest, and another against petitioner for $326,541.93, also bearing an 8 percent rate. In return for assuming 14701 Detroit's debt, petitioner received a note for $746,511 from the corporation. The CTC note was secured by any amounts which petitioner might receive under his agreements with the purchasers of the medical building, or the value of any interest in such building which petitioner might reacquire, and his interest in LCNBA.

Appendix D

OPINION

Cancellation of Indebtedness Income

The first issue we consider is whether petitioner must recognize income as a result of the forgiveness and discharge of the CTC mortgage. Section 61(a)(12) provides the general rule that gross income includes income from discharge of indebtedness. An exception to the general rule of income recognition applies, however, where the taxpayer is insolvent both before and after a debt cancellation. *Fifth Avenue-Fourteenth St. Corp. v. Commissioner,* 147 F.2d 453, 457 (2d Cir. 1944), revg. 2 T.C. 516 (1943); *Dallas Transfer & Terminal Warehouse Co. v. Commissioner,* 70 F.2d 95, 96 (5th Cir. 1934), revg. 27 B.T.A. 651 (1933); *Yale Avenue Corp. v. Commissioner,* 58 T.C. 1062, 1072-1073 (1972). To the extent that a cancellation of an insolvent taxpayer's indebtedness renders the taxpayer solvent, income is recognized in the amount by which the taxpayer's assets exceed liabilities immediately after the cancellation. *Haden Co. v. Commissioner,* 118 F.2d 285 (5th Cir. 1941), affg. a Memorandum Opinion of the Board of Tax Appeals dated October 20, 1939; *Estate of Delman v, Commissioner,* 73 T.C. 15, 32 (1979); *Lakeland Grocery Co. v. Commissioner,* 36 B.T.A. 289, 291-292 (1937). Accordingly, we must apply the insolvency exception as of January 9, 1978, the date the discharge and forgiveness of the CTC mortgage occurred.[1]

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1. Petitioners claimed on their 1977 return that the discharge of the CTC mortgage occurred in that year. Respondent determined that the discharge occurred on January 9, 1978, the date the Bankruptcy Court approved the settlement between CTC and LCMCA forgiving $2,420,019 of the mortgage on the medical building and the date on which the sale of the medical building to Schulman occurred. Petitioners, on brief, apparently concede that the discharge occurred during 1978. Accordingly, we will treat the forgiveness and discharge as having occurred during 1978.

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In the case of a discharge occurring in the context of a partnership, this Court has applied the insolvency exception at the partner level.[2] *Gershkowitz v. Commissioner,* 88 T.C. 984, 1009 (1987). The Second Circuit, however, disagrees with our holding in *Gershkowitz. In Estate of Newman v. Commissioner,* 934 F.2d 426 (2d Cir. 1991), revg. T.C. Memo. 1990-230, the Second Circuit held that the insolvency exception should apply at the partnership level.

We need not resolve the issue of whether the insolvency exception should apply at the partner or partnership level, however, in order to decide the instant case.[3] Under the Second Circuit's holding in *Estate of Newman v. Commissioner, supra,* the insolvency exception applies if the partnership is insolvent.[4] Respondent has made no argument, however, that petitioner is required to recognize income under the Second Circuit's partnership level analysis in *Estate of Newman,* and we accordingly deem the issue conceded. Respondent does contend

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2. In the Bankruptcy Tax Act of 1980, Pub. L. 96-589, 94 Stat. 3411, Congress provided that the insolvency exception is to be applied at the partner level. Sec. 108(d)(6); *Gershkowitz v. Commissioner,* 88 T.C. 984, 1007-1008 (1987). Such enactment, however, applies only to transactions occurring after 1980, and therefore does not apply to the instant case. Bankruptcy Tax Act of 1980, Pub. L. 96-589, sec. 7(a), 94 Stat. 3389.

3. The parties disagree as to petitioner's share of the cancellation of debt income that respondent contends LCMCA realized. Inasmuch as we hold below that petitioner recognizes no such income, we do not reach such issue.

4. Generally, a partnership is insolvent when the value of its nonexempt property, together with the value of the separate nonexempt property of its general partners, is less than its debts. See 11 U.S.C. sec. 101(26)(B) (1982); Ohio Rev. Code Ann. sec. 1336.02 (Baldwin Supp. 1991).

that petitioner realized income under this Court's partner-level analysis in *Gershkowitz*, and so we must decide whether petitioner was insolvent before and after the cancellation and discharge of the CTC mortgage.

Respondent argues that petitioners have failed to establish that petitioner was insolvent subsequent to the discharge. Respondent's contention is grounded upon the assertion that the evidence offered by petitioners at trial was insufficient to sustain their burden of proof. Respondent points to the relatively few number of documents offered by petitioners with respect to petitioner's business affairs and the fact that petitioners relied primarily upon the testimony of petitioner and his accountants to satisfy their burden of proof.

Contrary to respondent's assertion, we do not think that petitioners' failure to introduce additional documents represents an effort by them to avoid presenting unfavorable evidence. Rather, what appears to have been extensive documentation of petitioner's affairs at the time in question, was not available at the time of trial. The trial in the instant case was held 12 years after the transactions in issue, and many documents pertaining to the financial condition of petitioner's various enterprises were transferred to new owners when the entities were sold, were lost in office moves, or were discarded after LCMCA's bankruptcy proceeding ended. Furthermore, petitioner's accountant's car, which contained many of petitioner's original documents, was stolen in 1983 and never recovered. Nonetheless, petitioners were able to place in evidence copies of certain of such missing documents. On balance, we find that the relative paucity of documents is more attributable to the ravages of time and events beyond petitioners' control than to trial tactics. Moreover, at trial we found the witnesses to be credible, and so, with certain

exceptions noted below, we credit their testimony as sufficient to enable us to decide whether petitioner was solvent on the date in question.

To resolve the solvency issue, we must decide whether petitioner had a positive net worth subsequent to the discharge and the extent of any increase in net worth attributable to such discharge. Accordingly, we must value each of petitioner's assets and liabilities as of January 9, 1978.

The valuation of property is a question of fact, to be decided on the basis of all surrounding facts and circumstances. *Crowley Milner & Co. v. Commissioner,* 689 F.2d 635, 636 (6th Cir. 1982), affg. 76 T.C. 1030 (1981); *Hamm v. Commissioner,* 325 F.2d 934, 938 (8th Cir. 1963), affg. T.C. Memo. 1961-347; *Estate of Jephson v. Commissioner,* 87 T.C. 297, 303 (1986); *Skripak v. Commissioner,* 84 T.C. 285, 320 (1985). Although we must consider the entire record, we have broad discretion to decide what facts are most important in reaching our conclusion because "finding market value is, after all, something for judgment, experience, and reason". *Colonial Fabrics, Inc. v. Commissioner,* 202 F.2d 105, 107 (2d Cir. 1953), affg. a Memorandum Opinion of this Court dated January 22, 1951. See also *Hamm v. Commissioner, supra* at 940 (ascertaining fair market value is a question of judgment rather than mathematics). We, however, must logically explain how we arrived at our conclusion. *Estate of Gilford v. Commissioner,* 88 T.C. 38, 50 (1987).

Petitioners have introduced expert opinion testimony in support of the claimed value of certain of petitioner's property on the date in question. We evaluate such opinion in light of the demonstrated qualifications of the expert and all other evidence of value. *Parker v. Commissioner,* 86 T.C. 547, 561 (1986). As the

trier of fact, however, we are not bound by the opinion of an expert witness where such opinion is contrary to our judgment. *Helvering v. National Grocery Co.*, 304 U.S. 282, 295 (1938); *Estate of Kreis v. Commissioner*, 227 F.2d 753, 755 (6th Cir. 1955), affg. T.C. Memo. 1954-139; *IT&S of Iowa, Inc. v. Commissioner*, 97 T.C. 496, 508 (1991), on appeal (8th Cir. 1992). While we may accept the opinion of an expert in its entirety, *Buffalo Tool & Die Manufacturing Co. v. Commissioner*, 74 T.C. 441, 452 (1980), we may be selective in the use of any portion of such an opinion. *Parker v. Commissioner, supra* at 562. Moreover, even if only one party introduces an expert valuation, we are not required to accord such valuation total acceptance. *Estate of Gilford v. Commissioner, supra* at 56. If the opposing party shows to our satisfaction a substantial error in the expert's testimony, appropriate adjustments will be made. *Estate of Gilford v. Commissioner, supra* at 56. With the foregoing principles in mind, we will decide the value of petitioner's assets.

Petitioner's Assets

Marwood

Petitioners contend that the value of petitioner's 100 percent interest in Marwood on January 9, 1978, was $6,662, the excess of assets over liabilities shown on the balance sheet incorporated in its 1977 tax return. Respondent contends that Marwood had much greater value due to the management and consulting agreement petitioner had signed with Mr. Schulman covering the medical building. Respondent also points to the compensation paid to Marwood's employees, principally petitioner, contending that Marwood would have been profitable had so much of its income not been paid out for such purposes.

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Petitioners did not take into account any earning potential in valuing Marwood because they claimed it would have none without petitioner, who would have left its employ had the company been sold to a third party. Petitioners contend that all of Marwood's business depended upon petitioner's control of the properties it managed. A "key man" discount is appropriate where the value of a corporation is dependent upon the services of an individual. *Estate of Huntsman v. Commissioner,* 66 T.C. 861, 879 (1976); *Estate of Feldmar v. Commissioner,* T.C. Memo. 1988-429; *Estate of Yeager v. Commissioner,* T.C. Memo. 1986-448. Petitioner's ability to leave the employ of Marwood at will and to set up a competing business, which would enjoy the benefit of his connections, would substantially depress the amount a buyer would be willing to pay for Marwood's stock. See *Estate of Maddock v. Commissioner,* 16 T.C. 324, 330-332 (1951). Furthermore, the absence of income from the company due to the large amount of compensation paid petitioner would also make Marwood exceedingly unattractive to a potential buyer. *Royce C. McDougal, M.D., Inc. v. Commissioner,* T.C. Memo. 1985-64.

Marwood possessed contract rights of its own, which it would continue to hold even if petitioner were to leave upon a sale. The contracts with entities controlled by petitioner, however, ran for only a year and could be cancelled on 30 days' notice, except the medical building contract which had a 2-year life with the terms governing cancellation related to Marwood's performance under it. Although the contract rights constituted a component of the value of the Marwood stock which should be taken into account in valuing it, the amount by which such contracts increased the value of the Marwood stock is uncertain and speculative. We therefore do not adjust the value of the stock to take account of them.

Accordingly, we accept petitioners' value of the Marwood stock at $6,662.[5]

14701 Detroit Corp.

Petitioner owned all of the stock in 14701 Detroit, the principal assets of which were the 7-story INA office building and annex and the 3-story Lakewood Center Building located in downtown Lakewood. Petitioner also held a note due from the corporation in the amount of $746,511, which was issued when CTC exchanged a note it held in such amount for a nonrecourse note on which petitioner was the obligor. Petitioners contend that the corporate stock and note had no value on January 9, 1978, because the properties had a negative cash flow in the amount of $100,000, and because the corporation was in default on the first and second mortgages on the buildings and on the lease payments for the land on which they stood. Furthermore, the value of the properties was less than the liabilities to which they were subject. Respondent counters by pointing to the fact that in May 1979 petitioner sold his stock in 14701 Detroit Corp. for $1,740,157 and that petitioner never took a deduction for worthlessness on account of either the stock or note.

The increase in value relied on by respondent is largely attributable to petitioner's success in leasing spaces in the buildings to Control Data Corp., a high quality tenant. Such lease

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5. Respondent also contends that Marwood leased from the City of Lakewood certain land adjacent to the INA and Lakewood Center buildings that was used for parking, and held an option to buy such land. Such land, however, was actually leased by the predecessor of 14701 Detroit Corp., which had been known as Marwood, Inc. at the time the lease was signed but which was in fact a different corporation from the one we consider in the instant case. Accordingly, we do not consider such lease among Marwood's assets.

was not made, however, until March 30, 1978, and, due to several circumstances, petitioner could not count on Control Data signing a lease at the time of the debt discharge. Control Data wanted more space at such time, and was considering moving elsewhere. Before Control Data would agree to stay, petitioner had to convince Control Data that he could provide the extra space in 14701 Detroit's buildings, which he could obtain only by persuading other tenants in the buildings to relocate. Control Data's lease provided that it could terminate such lease if certain of the extra space were not available by the end of August 1978. We find that it was uncertain in January 1978 whether petitioner would be able to accommodate Control Data, as the two did not even begin serious negotiations until after the LCMCA bankruptcy proceeding ended. Consequently, we find that the amount for which the stock was sold in May 1979 does not represent its value as of January 9, 1978.

In order to establish the value of petitioner's interest in 14701 Detroit, petitioners introduced the expert testimony of Mr. Wesley Baker. Mr. Baker valued the buildings owned by 14701 Detroit using the income forecast method. He estimated income and expense using actual expenses for 1977, which he found were within industry norms, adjusting the historical data by certain percentages to stabilize them, and discounting the income by a risk-adjusted capitalization factor. Based on his calculations, Mr. Baker concluded that the buildings were worth $4,605,000 on January 10, 1978. Mr. Baker also valued the buildings under the comparable sales approach, which yielded a value of $4,656,000, after adjusting the comparables to take account of the fact that 14701 Detroit did not own the land upon which the buildings stood. Mr. Baker opined that the value yielded by the income approach was the most reliable indicator of the buildings' value on the relevant date because they were income-producing properties which a buyer would value on such basis and because of the

relative paucity of comparable building sales at such time. Respondent has not pointed to any serious flaws in Mr. Baker's methodology or results, and we have found none. Accordingly, we accept Mr. Baker's opinion as to the value of the subject properties. Adding such value to the value of 14701 Detroit's other assets, which we will assume equal the figures shown on the May 1978 balance sheet, its total assets on the relevant date equaled $4,688,432.

14701 Detroit, however, owed substantial amounts in the form of mortgages and rent due under its land lease. Petitioners' primary evidence as to such liabilities is a balance sheet prepared at the end of May 1978; both petitioner and his accountant testified that the figures represented on such balance sheet approximated the liabilities outstanding on January 9, 1978. Respondent asserts that such figures are unreliable. We, however, are convinced that the properties were encumbered by mortgages as of January 9, 1978. We also find the balance sheet sufficiently corroborative of the testimony of petitioner and his accountant to allow us to render our best estimate of the outstanding amount at such time.

In making our estimate, however, we do not accept *in toto* the figures in the balance sheet reflecting current liabilities, as such figures could include liabilities accruing after January 9, 1978. It appears that until rent under the new Control Data lease began in June 1978, 14701 Detroit's cash flow was negative, so liabilities were probably increasing through the end of May. Accordingly, the liability figures shown appear to be higher than they would have been in January. Accordingly, we find that petitioners have established that 14701 Detroit's liabilities were $5,063, 762 as of January 9, 1978. We note that actual liabilities on such date may have been higher, as 14701 Detroit was also in default on its lease payments, which equaled approximately $175,000 per year;

however, petitioners have not proved the amount of such additional liabilities. Nonetheless, because the total liabilities which we have been able to estimate with reasonable accuracy exceed the value of the corporate assets and take priority over the note owed petitioner, we hold that his stock and note had no net value as of January 9, 1978.

Eastates Gas Producing Co.

Petitioners claim that petitioner's equity interest in Eastates should be valued at $20,000, based on capitalization of its projected dividend income. We accept petitioners' valuation as reasonable given the level of dividends actually paid to petitioner and the condition of the company. Petitioners, however, claim that no value should be assigned to the $100,000 debenture. Petitioner maintains that the debt was written off prior to January 9, 1978, and that the company had fallen apart by that time.

We find petitioner's testimony concerning Eastates' financial condition credible. The available evidence suggests that Eastates was winding down, and that repayment of the $100,000 debenture was beyond its means. In fact, petitioner was never repaid the money he lent. Consequently, we ascribe no value to the debenture.

RPIA Partnership Interest

Petitioners argue that the value of petitioner's interest in RPIA was negative on January 9, 1978, and that petitioner's liability for the obligations of RPIA wiped out any positive net worth he may have had on such date. Respondent, on the other hand, argues that petitioners have undervalued RPIA's assets, principally the Westlake, and accordingly have understated the value of the partnership interest on the valuation date. After due consideration, we agree with petitioners.

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In support of the value claimed, petitioners introduced Mr. Baker's expert valuation of the Westlake and the land on which it stood, which concluded that their fair market value was $1,095,000. The report's conclusion was based on the conclusion that the highest and best use of the building and the 2.5 acres on which it stood was as rental apartments, and that the best use of the remaining 2.5 acres was for a condominium development. Mr. Baker accordingly valued the Westlake using the income expected from such use, based on historical data, and valued the balance of the land using comparable sales. Respondent argues that the Westlake should be valued on the basis of its use as condominiums, instead of rental apartments.

It is a basic principle of valuation that the fair market value of property must reflect its highest and best use, whether or not the taxpayer intends to put it to such use. *Stanley Works v. Commissioner,* 87 T.C. 389, 400 (1986). The highest and best use of property is "the reasonable and probable use that supports the highest present value" of property. *Frazee v. Commissioner,* 98 T.C. 554, 563 (1992) (quoting *Symington v. Commissioner,* 87 T.C. 892, 897 (1986)). A use may be considered highest and best if it is a use —

> for which the property is adaptable and needed or likely to be needed in the reasonably near future * * *, not necessarily as the measure of value, but to the full extent that the prospect of demand for such use affects the market value while the property is privately held. * * * [*Olson v. United States,* 292 U.S. 246, 255 (1934).]

Speculative or remote uses of property are not to be considered. *Stanley Works v. Commissioner,* 87 T.C. at 401-402.

Mr. Baker testified that the highest and best use of the Westlake was not as condominiums, citing an overbuilt market, high interest rates, and the difficulty of converting the building. We accept Mr. Baker's opinion, and we find such circumstances indicated that, as of the valuation date, the Westlake would not be needed for condominium use in the reasonably near future, rendering such use remote. In fact, the Westlake was not converted into condominiums until 1982, some 4 years later. At trial, respondent did not offer any credible evidence to counter Mr. Baker's opinion. Consequently, we accept Mr. Baker's valuation of the Westlake at $1,095,000 on such date. Respondent does not dispute that RPIA's obligations exceeded that amount. Accordingly, we find that petitioner's interest in RPIA had no net value as of January 9, 1978.

LCNBA Partnership Interest

Petitioners contend that petitioner's interest in LCNBA was worthless as of January 9, 1978, because the terms upon which Detroit Belle entered such partnership in early 1977, precluded petitioner from receiving any distributions from the partnership until 1987 at the earliest. Respondent contends that the partnership interest had some value, citing the $2,622,420 of capital gain reported on petitioner's 1977 return. Petitioners reply that such gain was "phantom gain" reported to take account of the decrease in petitioner's share of partnership liabilities resulting from Detroit Belle's assumption of such liabilities, as required by sections 752, 741, 733, and 731. Petitioners point out that petitioner received no cash distribution in connection with Detroit Belle's admission. We agree with petitioners and attach no significance to such phantom gain. Moreover, we also note that petitioner's interest in LCNBA secured a $1,000,000 nonrecourse note owed to CTC, which would eliminate petitioner's equity in

such interest. Accordingly, we find that petitioner's interest in LCNBA had no net value as of January 9, 1978.

LCNA Partnership Interest

Petitioners contend that petitioner's 20-percent interest in LCNA should be valued at $23,167, the amount of his capital account as of December 31, 1977. Respondent contends that such interest should be valued as 20 percent of the $138,510 book value of LCNA's assets. Petitioners contend the book value overstates the actual value of the assets, as petitioner testified that the market for commercial land in Lakewood was in collapse and that efforts to sell the property would have been futile. Petitioners, however, have made no attempt to quantify the amount of discount that should be applied to the book value of the land, and so we will accept such figure as the most reliable indicator of its value as of January 9, 1978. Accordingly, we find that the value of petitioner's interest in LCNA to be 20 percent of the book value of the assets of LCNA, net of the partnership's liabilities, or $26,687, as contended by respondent.

Associates for Investment in Lakewood

Petitioners contend that petitioner's interest in AFIL and its $22,500 note had no value as of January 9, 1978. Respondent argues that petitioners have failed to establish worthlessness. After considering the evidence, we find that petitioners have not entirely carried their burden of proof. AFIL had a negative cash flow position during the relevant time, and petitioner was obliged to make substantial cash contributions to it. Several months following the debt discharge, AFIL found a buyer who assumed the mortgages in exchange for the building. Such circumstances indicate that petitioner had no equity in the partnership as of

January 1978. Petitioners, however, have not succeeded in establishing that petitioner's $22,500 note from AFIL was worthless as of the relevant time. Mr. Carroll was also a general partner in AFIL, and accordingly, was liable for its debts. Petitioners, however, have failed to show that Mr. Carroll's separate property was insufficient to pay the partnership's liabilities, and so they have failed to establish that the note was worthless. Consequently, while we do not attribute any value to petitioner's interest in AFIL, we will include the face amount of the $22,500 AFIL note in calculating petitioner's net worth as of January 9, 1978.

Venture Associates

Petitioners contend that petitioner's interest in Venture was worth $20,000, based on a capitalization of its income stream. Respondent contends that petitioners have not offered any evidence of value aside from petitioner's own testimony. An owner of property, however, may testify as to its value. *Multibestos Co. v. Commissioner,* 6 B.T.A. 1060 (1927). Based on the income petitioners reported from the investment, petitioner's valuation appears reasonable. Furthermore, respondent has not pointed to any specific flaws in petitioner's valuation. Consequently, we find that petitioner's interest in Venture was worth $20,000 as of January 9, 1978.

Respondent has suggested that petitioner also owned an interest in Ashland Oil which he failed to take into account. However, based on the evidence, we are satisfied that petitioner held no interest in Ashland Oil on January 9, 1978. Ashland simply distributed to petitioner the amounts he was due by virtue of his interest in Venture.

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Tucker Land Co.

Petitioners contend, based on petitioner's testimony, that his interest in Tucker was worthless on the date of discharge. Respondent contends that petitioners have introduced no evidence to corroborate or support petitioner's testimony, which respondent characterizes as unreliable. We, however, find petitioner's valuation to be reasonable, inasmuch as Tucker was producing losses at the time in question. Moreover, petitioner held a fairly small interest in Tucker, and so its value would be commensurately minor in any event. Accordingly, we find that petitioner's interest in Tucker had no value as of January 9, 1978.

Account Receivable from LCMCA

Petitioner was due $32,640, his share of the $64,000 cash distribution. Both parties agree that such amount should be included in petitioner's assets without discount.

Option Agreement

Respondent contends that petitioner's assets should include the purchase option agreement negotiated with Mr. Schulman. Petitioners contend that there was no such agreement, but we find that, inasmuch as CTC named it as part of petitioner's security for a $1,000,000 nonrecourse note, such an agreement more likely than not existed, although a copy was not placed in evidence. Not knowing the terms of such agreement, however, and considering petitioner's precarious financial position at the time of the discharge, it is impossible to assign any value to such agreement.

The same can be said of any rights to refinancing or sale proceeds granted to petitioner by the Management and Consulting

Agreement he made with Mr. Schulman concerning LCMCA's medical building. The prospect of receiving anything on their account was too speculative on January 9, 1978, to permit any value to be assigned to them. Moreover, such rights served as security for CTC's $1,000,000 nonrecourse note, and we think it is safe to assume that such liability eliminated any equity petitioner may have had in them.

Miscellaneous Assets

Petitioner held certain other assets in addition to his business holdings and investments. Certain of such assets are exempt from creditors' claims under Ohio law, and so are not to be counted in deciding the increase in net worth occasioned by the debt discharge, as such assets are not thereby freed from creditors' claims. *Cole v. Commissioner,* 42 B.T.A. 1110 (1940); *Hunt v. Commissioner,* T.C. Memo. 1989-335; *Estate of Marcus v. Commissioner,* T.C. Memo. 1975-9.

Petitioner held a checking account with a balance of $387 as of December 31, 1977, and petitioners contend that no material changes in such account occurred between such time and January 9, 1978. Ohio Rev. Code Ann. sec. 2329.66(A)(4)(a) (Baldwin 1991) exempts a debtor's cash on hand from creditors' claims to the extent of $400. The checking account therefore is not to be counted in deciding the extent of petitioner's solvency. Similarly, the cash value of petitioner's life insurance policy should be excluded, as it is exempt under Ohio Rev. Code Ann. sec. 3911.10. Personal property, such as apparel and household items are exempt to the extent of $200 per item under Ohio Rev. Code Ann. sec. 2329.66(A)(3) and (4)(b), respectively. Petitioners valued such property at $9,000, and we find that all of it should be excluded. Ohio Rev. Code Ann. sec. 2329.66(A)(2) exempts one automobile

to the extent of $1,000. Petitioner's 1970 Buick was valued at $1,000, and we find such automobile should be excluded from the net worth calculation. A 1977 Buick owned by petitioners and valued at $7,000, however, is not excludable.

Petitioner's Liabilities

At trial, petitioner testified that he owed certain sums to various individuals, but respondent contends that petitioners have not proved the existence of such debts because copies of notes were not introduced at trial, nor were the creditors called to testify in their behalf. Petitioner, however, testified credibly concerning such debts, and his tax returns show deductions were claimed for interest payments to the persons named as his creditors.[6] Consequently, we find that, on January 9, 1978, petitioner personally owed the following amounts: $20,000 to Helen Fowerbaugh; $7,000 to Nick Laslovich; $64,800 to Continental Bank; $42,700 to LCNA. Because petitioner was a general partner of RPIA, and all of such partnership's liabilities were recourse as to him, we will also take into account the amount by which RPIA's liabilities exceeded its assets as of the valuation date, or $311,407.

CTC held a nonrecourse note from petitioner in the amount of $1,000,000, which was secured by his interest in LCNBA, his option to reacquire the medical building, and certain cash flows from such building which petitioner might subsequently receive. Such note was issued January 9, 1978, in exchange for a $325,000 personal note owed by petitioner and $746,511 of debt owed by 14701 Detroit, which petitioner assumed. Petitioners do not

6. We note that while the statements in petitioners' tax returns do not establish the fact that the interest payments were actually made, *Wilkinson v. Commissioner*, 71 T.C. 633, 639 (1979), the claim of interest deductions provides some corroboration of Mr. Babin's testimony as to the existence of such debts.

contend that such nonrecourse note should be counted in arriving at petitioner's net worth, nor do we consider it appropriate to do so. Cf. *Estate of Delman v. Commissioner,* 73 T.C. 15, 32-33 (1979). See also Rev. Rul. 92-53, 1992-27 I.R.B. 7 (July 6, 1992). The foregoing discussion of petitioner's net worth as of January 9, 1978, is summarized in the Appendix.

Based on the foregoing, we find petitioner was insolvent both before and after the discharge of the CTC mortgage. Accordingly, he recognizes no income from cancellation of indebtedness here. See *Estate of Newman v. Commissioner,* 934 F.2d 426 (2d Cir. 1991), revg. T.C. Memo. 1990-230; *Gershkowitz v. Commissioner,* 88 T.C. 984 (1987).

Gain Recognized Incident to Reduction in Partnership Liabilities

Respondent determined that petitioners recognized capital gain upon the forgiveness and discharge of the CTC mortgage debt because the deemed cash distribution attributable to the reduction in the partnership's liabilities exceeded their adjusted basis in their partnership interests. Secs. 731(a), 741, 752(b). Petitioners do not dispute the capital gain respondent determined with respect to petitioner Betty Boehm Babin, but do dispute the determination with respect to petitioner. We will accordingly consider such objections. In the statutory notice of deficiency, such capital gain was calculated generally as follows:

Partnership basis

	Total	C. Stephen Babin
Distribution of liabilities	100%	75%
Partnership interest	100%	51%

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Basis increases:		
Cleveland trust liabilities	$5,170,019	$3,877,514
Unsecured creditors	6,500	4,875
Legal and accounting	20,000	15,000
Total basis increases	5,196,519	3,897,389
Basis decreases:		
Ordinary losses, 1974-78	(2,356,018)	(1,201,569)
Cash distribution, 1978	(64 000)	(32,640)
Adjusted basis	2,776,501	2,663,180
Reduction in partnership liabilities	(5,270,019)	(3,952,514)
Capital gain	2,493,518	1,289,334

Petitioners argue that certain modifications of respondent's calculation should be made. First, they argue that petitioner should be treated as having received $99,923 of income instead of $279,776 of loss from the partnership in 1977. Such income apparently results from considering the forgiveness of the CTC mortgage as having occurred in 1977. We, however, have previously held that the forgiveness and discharge of the CTC mortgage occurred in 1978. Consequently, there is no justification for adjusting the ordinary losses determined by respondent for 1977.

Petitioners also argue that petitioner's basis in his interest in LCMCA should be increased by $1,234,210, the amount of cancellation of indebtedness income which he would have recognized on the forgiveness of the CTC mortgage absent application of the insolvency exception. An increase in basis is

only allowable, however, where the debt cancellation income is actually recognized, and no basis increase is warranted where application of the insolvency exception prevents such recognition. *Gershkowitz v. Commissioner,* 88 T.C. at 1008. See also *Estate of Newman v. Commissioner,* 934 F.2d at 434. Consequently, petitioner is allowed no basis increase because no income was recognized from forgiveness of the CTC mortgage. *Gershkowitz v. Commissioner, supra* at 1009.

Petitioners also claim that they should be allowed a capital loss of $241,910, which they claim is petitioner's share of the loss experienced by LCMCA on sale of the medical building to Mr. Schulman. On its 1978 partnership return of income, LCMCA claimed a $442,264 ordinary loss on the sale of the building, 51 percent of which, $225,555, respondent allowed petitioner as an ordinary loss. Consequently, the loss on the sale of the building has already been taken into account, and petitioners are not entitled to an extra capital loss deduction. Moreover, petitioners have not established that respondent's determination as to the amount of the loss was erroneous.

In determining the amount of the capital gain realized by petitioners from LCMCA in 1978, respondent included in petitioner's share of the reduction in partnership liabilities $75,000 of the $100,000 portion of the sale price for the medical building exceeding the amount of the CTC mortgage outstanding after the partial forgiveness. Petitioners contend that only the reduction in petitioner's share of LCMCA's liabilities effectuated by the forgiveness and discharge of the CTC mortgage, or $3,877,514, and a cash distribution of $32,640 received from LCMCA should be considered in calculating the gain to be recognized. We find that the basis reduction attributable to the excess payment should be adjusted, but not excluded entirely.

First, the $100,000 excess payment incorporates the $64,000 distributed in cash to the partners, which was shared according to their shares of income and has already been taken into account as a cash distribution reducing basis. Accordingly, it must be subtracted to avoid double counting. Second, the remainder of the excess payment was used to pay outstanding liabilities of LCMCA or expenses connected with the sale of the medical building. To the extent that such payment represents a decrease in petitioner's share of partnership liabilities, petitioner is treated as receiving a cash distribution from the partnership reducing his basis. Sec. 752(b). Respondent has allowed petitioner a basis increase of $19,875 on account of such liabilities, and petitioner's basis must be reduced by such amount to take account of such reduction.

With respect to the remaining liabilities against which the excess payment was applied, we note that petitioner would have been entitled to a corresponding increase in his basis on account of the remaining liabilities paid with the sales proceeds, which respondent has not allowed. *La Rue v. Commissioner,* 90 T.C. 465, 478-479 (1988). If petitioner's basis is to be reduced by the liability decrease occasioned by the application of the excess payment to such liabilities, he would have been entitled to an offsetting basis increase for his share of such liabilities, which washes out any change resulting from the basis reduction. Furthermore, that to the extent that a portion of the sale proceeds was used to pay expenses incident to the sale, the amount realized by LCMCA on the sale should be reduced by the amount so used. *Southern Pacific Transportation Co. v. Commissioner,* 75 T.C. 497, 586 n.86 (1980), and cases cited therein. Consequently, the excess payment is to be taken into account only to the extent of the basis increase allowed by respondent on account of liabilities paid with such payment, or $19,875.

Appendix D

On their 1978 return, petitioners claimed an ordinary loss of $580,805, asserting that an abandonment of their interest in LCMCA had occurred. Although their petition alleged respondent erred in disallowing such deduction, petitioners do not maintain they are entitled to such deduction in their brief. Accordingly, we deem the issue conceded. *Sundstrand Corp. v. Commissioner,* 96 T.C. 226, 344 (1991); *Rybak v. Commissioner,* 91 T.C. 524, 566 (1988). We note, moreover, that petitioners have not established that an abandonment of their interest in LCMCA occurred, or that the loss equaled the amount claimed. Petitioners have not shown that they intended to abandon their interest in LCMCA, nor is there evidence of an act of abandonment. *Citron v. Commissioner,* 97 T.C. 200, 208-209 (1991); *Pallan v. Commissioner,* T.C. Memo. 1986-76. The transactions leading to the dissolution of LCMCA are governed by section 731(a), and so gain or loss resulting therefrom is capital in nature. *La Rue v. Commissioner,* 90 T.C. 465, 482-487 (1988); *Pietz v. Commissioner,* 59 T.C. 207 (1972); *Tapper v. Commissioner,* T.C. Memo. 1986-597. Moreover, after the transactions disposing of the medical building and the discharge of the CTC mortgage, petitioners' basis in their LCMCA interest was zero, so no amount of allowable loss exists.

Loss on Disposition of Partnership Interest in AFIL

Petitioners originally claimed a business bad debt loss of $80,095 for 1978 with respect to AFIL, reflecting advances made to the partnership by petitioner which he never recovered. Respondent recharacterized such amount as a capital contribution, and allowed such amount as a capital loss offsetting capital gain recognized on dissolution of AFIL after the sale of its building, netting a capital loss of $48,057. Petitioners concede the correctness of respondent's recharacterization of the $80,095 as a capital loss. Respondent's determination as to the amount of capital loss recognized is accordingly sustained.

Appendix D

1977 Net Operating Loss Carryforward of Mrs. Babin

Respondent disallowed $32,357 of 1977 net operating losses which petitioner Betty Boehm Babin sought to carry forward to 1978. Petitioners argue that they are entitled to claim such carryforwards, but the only evidence they adduce is Mrs. Babin's 1977 income tax return. At trial, petitioner Betty Boehm Babin did not testify as to such losses. A tax return, however, is merely a statement of the taxpayer's claim and does not establish the truth of the matters set forth therein. *Wilkinson v. Commissioner,* 71 T.C. 633, 639 (1979); *Roberts v. Commissioner,* 62 T.C. 834, 837 (1974); *Halle v. Commissioner,* 7 T.C. 245, 247248 (1946), affd. 175 F.2d 500 (2d Cir. 1949). Petitioners accordingly have not presented sufficient evidence to establish their entitlement to the carryforwards. To reflect the foregoing,

Decision will be entered

under Rule 155.

Appendix D

Appendix

C. STEPHEN BABIN BALANCE SHEET AS OF 1/9/78
(immediately after Cleveland Trust debt forgiveness)

ASSETS

1. Cash	$ -0-
2. Stock Holdings	
a. Marwood, Inc. (100%)	6,662
b. 14701 Detroit Corp. (100%)	-0-
c. Eastates Gas	20,000
3. Partnership Interests	
a. Rockport Palisades Investment Associates ("RPIA") (78%)	-0-
b. Lakewood Center North Associates ("LCNA") (20%)	26,687
c. Lakewood Center North Building Associates ("LCNBA") (8 1/2%)	-0-
d. Associates for Investment In Lakewood ("AFIL") (40%)	-0-
e. Venture Associates	20,000
f. Tucker Land Co.	-0-
4. Notes	
a. 14701 Detroit Corp. (face value of $746,511)	-0-
b. RPIA (face value of $176,601)	-0-
c. AFIL (face value of $22,500)	22,500

Appendix D

5. Account Receivable from LCMCA	32,640
6. Option Agreement	-0-
7. Miscellaneous	
a. New England Mutual Life Insurance Policy CSV	-0-
b. Personal Property	-0-
c. Automobiles	
i. 1970 Buick	-0-
ii. 1977 Buick Electra	7,000
TOTAL ASSETS	$135,489

LIABILITIES AND NET WORTH

1. Notes Payable	
a. Helen L. Fowerbaugh	$ 20,000
b. Nick Laslovich	7,000
c. Continental Bank/ENB	64,800
d. LCNA	42,700
e. Cleveland Trust ($1,000,000 nonrecourse)	-0-
2. Partnership Liabilities as General Partner of RPIA	311,407
TOTAL LIABILITIES	$445,907
NET WORTH	($310,418)

APPENDIX E — STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED

(a) *General definition*

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

(3) Gains derived from dealings in property;

* * *

(12) Income from discharge of indebtedness;

* * *

SEC. 701. PARTNERS, NOT PARTNERSHIP SUBJECT TO TAX

A partnership as such shall not be subject to the income tax imposed in this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

SEC. 702. INCOME AND CREDITS OF PARTNER

(a) *General rule*

In determining his income tax, each partner shall take into account separately his distributive share of the partnership's —

Appendix E

(1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,

(2) gains and losses from sales or exchanges of capital assets held for more than 1 year,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170(c)),

(5) dividends with respect to which there is provided an exclusion under section 116 or a deduction under part VIII of subchapter B,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and

(8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

Appendix E

(b) *Character of Items Constituting Distributive Share.* — The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

* * *

SEC. 705. DETERMINATION OF BASIS OF PARTNER'S INTEREST

(a) *General rule*

The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b) be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests) —

(1) increased by the sum of his distributive share for the taxable year and prior taxable years of —

(A) taxable income of the partnership as determined under section 703(a),

(B) income of the partnership exempt from tax under this title, and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion;

(2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of —

(A) losses of the partnership, and

(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account; and

(3) decreased (but not below zero), by the amount of the partner's deduction for depletion under section 611 with respect to oil and gas wells.

* * *

SEC. 731. EXTENT OF RECOGNITION OF GAIN OR LOSS ON DISTRIBUTION

(a) *Partners*

In the case of a distribution by a partnership to a partner —

(1) gain shall not be recognized to such partner, except to the extent that any money

distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

(2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of —

(A) any money distributed, and

(B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 752(d)(2)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

* * *

SEC. 733. BASIS OF DISTRIBUTEE PARTNER'S INTEREST

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such

partner of his interest in the partnership shall be reduced (but not below zero) by —

(1) the amount of any money distributed to such partner, and

(2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

SEC. 752. TREATMENT OF CERTAIN LIABILITIES

(a) *Increase in partner's liabilities*

Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) *Decrease in partner's liabilities*

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

* * *

Appendix E

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.61-12 *Income from discharge of indebtedness.*

(a) *In general.* The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.

(b) *Proceedings under Bankruptcy Act.* (1) Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act (11 U.S.C. 32), of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. . . .

* * *

(2)

No. 94-256

FILED
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In the Supreme Court of the United States

OCTOBER TERM, 1994

C. STEPHEN BABIN AND BETTY BOEHM BABIN,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a partner may apply his share of a partnership's income from the discharge of indebtedness to increase his adjusted basis in the partnership even though, due to his insolvency, he did not recognize or pay tax on the partnership's income from the discharge of indebtedness.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 3a-18a) is reported at 23 F.3d 1032. The decision of the Tax Court (Pet. App. 21a-56a) is reported at 64 T.C.M. (CCH) 1357.

JURISDICTION

The judgment of the court of appeals (Pet. App. 19a-20a) was entered on May 6, 1994. A petition for rehearing was denied on July 7, 1994 (Pet. App. 1a-2a). The petition for a writ of certiorari was filed on August 4, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner C. Stephen Babin was a general partner in Lakewood Center Medical Construction Associates (LCMCA). He held a 51% interest in the income and losses of LCMCA and a 75% interest in its assets and liabilities (Pet. App. 4a). LCMCA's primary asset was a medical building which had been financed by a loan of more than $4 million from Cleveland Trust Company (*id.* at 23a). Largely as the result of this borrowing, petitioner's basis in LCMCA was originally $3.9 million (*id.* at 50a). His basis in the partnership was thereafter reduced to approximately $2.6 million, however, by his share of recurring partnership losses (that he was permitted to deduct against his individual income over the years) and by a cash distribution from the partnership (*ibid.*).

When LCMCA became unable to make required payments on its loan from Cleveland Trust, the bank foreclosed on the medical building. LCMCA then filed a petition under Chapter XII of the Bankruptcy Act. While that bankruptcy proceeding was pending, LCMCA reached an agreement to sell all of the partnership's assets—including the medical building—for $2,850,000. As part of the sale agreement, Cleveland Trust agreed to accept $2,750,000 from LCMCA in complete satisfaction of its outstanding debt and interest, thereby forgiving $2,420,019 of indebtedness. The bankruptcy court approved this settlement and dismissed the bankruptcy proceeding (Pet. App. 4a-5a, 23a).

2. In 1989, the Internal Revenue Service issued a notice of deficiency concerning certain income that petitioner failed to report from the transactions involving LCMCA (Pet. App. 5a). As is relevant here, the Service determined (i) that petitioner's 75% share of the dis-

charge of LCMCA's indebtedness upon the sale of its assets represented a deemed distribution to him of $3,982,514 under 26 U.S.C. 752(b), (ii) that this distribution exceeded petitioner's adjusted basis in LCMCA of $2,663,180, and (iii) that petitioner therefore recognized a capital gain of $1,289,334 from this transaction under 26 U.S.C. 731 (Pet. App. 5a).

3. Petitioner sought a redetermination of the deficiency in Tax Court, contending that he had no income from the discharge of indebtedness (Pet. App. 21a-22a). He argued first that, because he was insolvent both before and after the discharge of indebtedness, he was entitled to the benefit of the "insolvency exception" from the general rule (26 U.S.C. 61(a)(12)) that requires a discharge of indebtedness to be recognized as income. He further claimed that, under Section 705(a)(1)(A) of the Internal Revenue Code, 26 U.S.C. 705(a)(1)(A), he was entitled to apply his share of the partnership's discharge of indebtedness to increase his adjusted basis in LCMCA, thereby substantially reducing the capital gain that resulted from the deemed distribution under Section 752(b) (Pet. App. 50a).

The Commissioner of Internal Revenue argued in Tax Court that petitioner was not insolvent and was therefore required to recognize his share of the partnership's discharge of indebtedness as ordinary income. Alternatively, the Commissioner contended that, if petitioner was not required to recognize his share of the partnership's discharge of indebtedness income because he was insolvent, then petitioner could not apply that discharge of indebtedness to increase his adjusted basis in the partnership. As a result, petitioner remained liable for the entire amount of the capital gain resulting from the deemed distribution to him from the elimination of the partnership's liabilities (Pet. App. 49a-51a).

Pursuant to an agreement of the parties (Pet. Tax Ct. Br. 35-36; Resp. Tax Ct. Br. 18), the Tax Court applied the insolvency exception at the partner level. Following an evidentiary hearing, the Tax Court found that petitioner was insolvent both before and after the partnership transaction. The court therefore concluded that petitioner was entitled to the insolvency exception and did not have to recognize a share of the partnership's discharge of indebtedness income (Pet. App. 49a). The court agreed with the Commissioner, however, that petitioner could not increase his adjusted basis in LCMCA under Section 705(a) by the amount of his unrecognized share of the partnership's discharge of indebtedness income (Pet. App. 51a). The Tax Court therefore upheld the Commissioner's determination that petitioner was liable for tax on the full amount of his gain from the elimination of LCMCA's liabilities (*i.e.*, the amount by which his share of those liabilities exceeded his adjusted basis in the partnership).

4. The court of appeals affirmed (Pet. App. 3a-18a). The court held that, because petitioner was insolvent, he did not receive a distributive share of the partnership's discharge of indebtedness income (*id.* at 10a) and therefore "is not permitted to increase the adjusted basis of his interest in the Partnership" (*id.* at 11a). The court rejected petitioner's argument that this result negates the benefit that petitioner is to receive from the insolvency exception. The court noted that petitioner received the benefit of the exception by not recognizing his share of the discharge of indebtedness as ordinary income. The court further noted that, if petitioner were allowed to increase his adjusted basis by the unrecognized discharge of indebtedness income, this would permit him to "avoid tax on the deemed distribution of money to him of his interest in the liabilities that he

previously used to increase his adjusted basis" (*id.* at 14a). The court "refuse[d] to sanction such a windfall to petitioner" (*ibid.*).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or of any other court of appeals. Further review is therefore not warranted.

1. a. It is well established, as a general rule, that a debtor realizes taxable income upon the discharge or cancellation of indebtedness. 26 U.S.C. 61(a)(12); *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931). An exception to this general rule, however, is the so-called "insolvency exception." Under that judge-made exception, an insolvent debtor is deemed not to have realized income from the discharge of indebtedness if he remains insolvent after the discharge. See, *e.g.*, *Estate of Newman* v. *Commissioner*, 934 F.2d 426, 430 (2d Cir. 1991). [1]

The insolvency exception is relatively easy to apply in the ordinary case. With respect to the discharge of a debt owed by a partnership, however, application of the exception is complicated by the special rules governing the taxation of partners and partnerships. When a partnership assumes a liability, a partner's basis in the partnership is correspondingly increased because the liability is treated as if it were a contribution of money by the partner to the partnership. 26 U.S.C. 722. This increase in basis is significant because the deduction of a partner's share of partnership losses on the partner's

---

[1] This exception was codified in Section 108(a)(1)(B) of the Internal Revenue Code, effective for transactions occurring after December 31, 1980, subsequent to the tax year at issue in this case. 26 U.S.C. 108(a)(1)(B).

individual income tax return is permitted only to the extent of his adjusted basis in his partnership interest. 26 U.S.C. 704(d). When a partnership incurs a debt obligation, the partners are thereby enabled to deduct losses in excess of their actual contributions of cash or other property to the partnership.

The provisions of the Internal Revenue Code, however, seek to ensure that a partner does not increase his basis in a partnership by the amount of a liability for which he is not truly liable. When a partnership debt is discharged, the resulting decrease in a partner's share of the partnership's liabilities is therefore treated as a deemed distribution to the partner (26 U.S.C. 752(b)) and his basis in the partnership is correspondingly reduced (26 U.S.C. 733). The partner must recognize gain—treated as gain from the sale or exchange of the partnership interest—if, and to the extent that, the deemed distribution exceeds his adjusted basis. 26 U.S.C. 731(a), 741.

Separate from these rules governing basis adjustments are the rules governing the tax effect of a discharge of indebtedness. As noted above, under Section 61(a)(12), discharge of indebtedness represents income to the partnership which (under Section 702(a)) a partner ordinarily must recognize in reporting his individual income tax liability. When that occurs, the partner's basis in his partnership interest is increased (under Section 705(a)(1)) by the amount of taxable income allocated to him under Section 702(a).

These two sets of provisions "operate independently and simultaneously." *Gershkowitz* v. *Commissioner*, 88 T.C. 984, 1008 (1987). Taken together, they provide that, when a partner recognizes discharge of indebtedness income, the increase in his basis in his partnership interest (under Section 705(a)(1)) offsets the decrease in

basis (under Section 733) resulting from the deemed distribution to him attributable to the reduction in partnership indebtedness (under Section 752(b)). The result is that (i) the partner recognizes his distributive share of the partnership's discharge of indebtedness income, (ii) there is no net change in his basis in the partnership as a result of the discharge of indebtedness, and (iii) there is no capital gain to the partner under Section 731(a).

b. As the court of appeals recognized (Pet. App. 10a-11a), however, the effects on a partner of a discharge of partnership indebtedness are different when the insolvency exception applies. When a partner qualifies for that exception, he recognizes no income from the cancellation of the indebtedness (*id.* at 8a-9a). This benefits the partner by permitting him to avoid taxation on his share of the discharge of indebtedness income as ordinary income. The basis adjustments discussed above resulting from discharge of indebtedness income received by a partnership, however, occur only when a partner recognizes a share of that income. As the court of appeals ruled in this case (*id.* at 10a-11a), petitioner may not increase his basis in the partnership pursuant to Section 705(a) by his "share" of the partnership's discharge of indebtedness income because he is deemed (by the "insolvency exception") never to have received such a share.

The court's conclusion is correct. Because the insolvency exception applies in this case, no income has been realized by petitioner from the discharge of the partnership's indebtedness. See, *e.g.*, *Estate of Delman* v. *Commissioner*, 73 T.C. 15, 32 (1979) ("The theory of this exception is that *no accession to income has occurred* if after the debt cancellation, the taxpayer remains insolvent." (emphasis added)). To the extent

that the insolvency exception applies, the discharge of indebtedness is not "income" to petitioner for purposes of the Internal Revenue Code. Because he thus did not receive a distributive share of that income of the partnership, he is not permitted to increase his adjusted basis in the partnership under Section 705(a)(1)(A).

c. The insolvency exception is limited to the recognition of ordinary income upon the discharge or cancellation of indebtedness. It does not eliminate income earned from services or gain from the sale or exchange of property. Similarly, it does not apply to permit a partner to eliminate the capital gain realized from the deemed distribution to partners resulting from a reduction of partnership liabilities. See *Estate of Delman* v. *Commissioner*, 73 T.C. at 32 ("The insolvency exception applies only for cancellation of indebtedness income. For all other types of income, such as * * * gains from dealings in property, the solvency of the taxpayer is irrelevant.").

Petitioner's proposed, contrary application of the insolvency exception would produce illogical results. Under petitioner's theory, the insolvent partner would not only avoid tax on his share of the partnership's ordinary income from discharge of indebtedness, he would also increase his basis in the partnership as if a share of that income *had* been attributed to him. Petitioner thus seeks to capitalize an amount of partnership liabilities for which he was ultimately not liable, to deduct operating losses far in excess of his actual contributions to the partnership, and then to avoid recognizing the gain realized when the partnership liabilities are canceled. The courts of appeals have correctly recognized the abusive nature of petitioner's theory and have rejected it. See Pet. App. 17a-18a; *Estate of Newman* v. *Commissioner*, 934 F.2d at 433-434.

d. Petitioner argues that the decision in this case "directly contradicts the plain * * * language of 26 U.S.C. § 705(a)" (Pet. 7). That statute specifies that a partner's basis is to be increased by his "distributive share" of the "taxable income of the partnership" and the "income of the partnership exempt from tax" (26 U.S.C. 705(a)(1)(A) and (B)). As the court of appeals noted (Pet. App. 10a-11a), however, because of the application of the insolvency exception, petitioner simply did not receive any "distributive share" of the partnership's discharge of indebtedness income. There is thus no "income" to which Section 705(a) can apply. See *Estate of Delman* v. *Commissioner*, 73 T.C. at 32 ("no accession to income has occurred").

Contrary to petitioner's contention, this conclusion does not result in a "second level of taxation" (Pet. 8 n.3). Because of his insolvency, petitioner is not subject to tax on the partnership's discharge of indebtedness income. It is only the gain that he has realized from the elimination of his share of LCMCA's liabilities, which is entirely separate from the discharge of indebtedness income, that is subject to tax. As the court of appeals noted (Pet. App. 13a-14a), petitioner has thus received the full benefit of the insolvency exception.

2. Petitioner errs in contending (Pet. 13) that the decision in this case conflicts with *Estate of Newman* v. *Commissioner*, *supra*. In *Estate of Newman*, the Second Circuit applied the insolvency exception at the partnership level rather than (as in this case) at the partner level. See 934 F.2d at 432. In the present case, by contrast, the parties agreed that the insolvency exception should be applied at the partner level. Neither the Tax Court nor the court of appeals ruled on that question. See Pet. App. 8a-9a, 33a-34a. The question whether, in these circumstances, the insolvency

exception should be applied at the partner or the partnership level is therefore not properly presented for review by this Court in this case.[2] See *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 147 n.2 (1970) ("Where issues are neither raised before nor considered by the Court of Appeals, this Court will not ordinarily consider them."). Accord, *United States* v. *Williams*, 112 S. Ct. 1735, 1738 (1992); *Taylor* v. *Freeland & Kronz*, 112 S. Ct. 1644, 1649 (1992); *City of Springfield* v. *Kibbe*, 480 U.S. 257, 266 (1987).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[2] Moreover, this issue would have relevance to petitioner's claims only if it had been determined that the insolvency exception was *not* applicable. In this case, however, both the Tax Court and the court of appeals concluded that the insolvency exception does apply to petitioner (Pet. App. 9a, 49a). Petitioner simply disagrees with the courts below concerning the effect of the insolvency exception in the context of a partnership's discharge of indebtedness.